The New York Certified Public Accountant

VOL. XVIII — *November · 1948* — NO. 11

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

SIMPLIFIED PAYROLL PLAN

Recommended by Accountants

SAVES up to 66% Labor

"Built Like a Skyscraper"

SHAW-WALKER

Chrysler Building
New York 17, New York

SHAW-WALKER COMPANY 6
Chrysler Building, New York 17, N. Y.
Please send folder describing Simplified Payroll Plan.

Name..

Firm..

Address..

The Shaw-Walker Simplified Payroll Plan ordinates all records and entirely *elimin* figure-copying. The first posting of all earni and deductions is the last. There is no prelimin figuring and no figure need ever be copied.

Thousands of employers are already using time-saver upon recommendation of their countants. In every installation it has effe substantial *savings*—some as high as 66%.

More important, in every installation the figures are always in balance, *ready for quart reports* without the need for costly recheck

BEST NEWS—The entire payroll Plan costs more than the price ordinarily paid for new fo

SEE FOR YOURSELF—Whether the payroll 25 people or 25,000 you should see this t saver. Within ten minutes *you* can decide if it effect a worthwhile saving. We will gladly s you the Plan in your office or send descrip literature.

BUSINESS AND PERSONNEL OPPORTUNITIES

Help Wanted:	**20¢ a word, minimum $5.00.**
Situations Wanted:	**10¢ a word, minimum $2.00.**
Business Opportunities:	**15¢ a word, minimum $3.00.**

Box number, if used, counts as three words.

Closing Date—15th of month *preceding* date of publication.

BUSINESS OPPORTUNITIES

Practice Wanted

C.P.A. will purchase entire accounting practice or individual accounts, Metropolitan area. Liberal terms, Box 58, New York C.P.A.

Recommend This Ad-Man!

When clients ask, "Where's a good advertising man?" introduce this experienced, idea-full adman! Accept part-time, freelance, etc. Introductions reciprocated. Consult without obligation: Box 60, New York C.P.A.

Practice Wanted

Central and Upper New York State Area. C.P.A. 701 Loew Bldg., Syracuse, N. Y.

To Retiring Practitioners

Guaranteed LIFETIME INCOME with a minimum guarantee offered by established C.P.A. firm in Metropolitan area, or will purchase practice or accounts. Replies confidential. Box 62, New York C.P.A.

C.P.A. will purchase medium or small practice; consider managing accounts for overburdened practitioner; available special engagements. Box 57, New York C.P.A.

Sharing Office Space

C.P.A. would like to meet several men in our profession for the purpose of sharing expense in opening new office. References exchanged. Box 61, New York C.P.A.

HELP WANTED—MALE

Senior Accountant

Senior, with supervisory experience and report writing ability; background must include at least ten years diversified public and tax experience. Location Connecticut. Salary $6,000. Box 59, New York C.P.A.

SITUATIONS WANTED

Statistical Typing

Financial reports, tax returns, expertly typed — reasonable — confidential — 6 years certified experience. Thorough knowledge all details. Mu 2-3383 — days. Sp. 7-5827 evenings. Box 52, New York C.P.A.

SITUATIONS WANTED

C.P.A., exceptionally broad American, European experience, finance, taxes, systems; fluent French, German, seeks part-time arrangement. Box 63, New York C.P.A.

Per Diem

Certified Public Accountant, Society member, 34, 12 years diversified experience, available 1 or 2 days per week. Box 64, New York C.P.A.

Part-time Bookkeeper

Responsible, mature teacher-mother, experienced assistant bookkeeper under C.P.A., wishes 10 to 15 hours' work weekly Metropolitan area. Box 54, New York C.P.A.

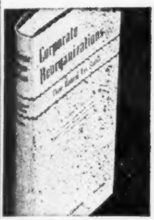
Important Books for Accountants to KNOW and USE

C.P.A. Law Questions & Answers

By **JOHN C. TEEVAN,** *Professor Emeritus of Business Law, Northwestern University*

MORE THAN 820 questions in commercial law, comprising the examinations from November 1935 to May 1947, *prepared by the American Institute of Accountants—with answers by an authority.* Numerous practical suggestions on the technique of writing the examination papers; recommendations to candidates by the A.I.A. Board of Examiners. Appendix includes Negotiable Instruments Law, Uniform Sales Act, Uniform Partnership Act. *Revised Edition. Loose leaf, binder.* **(509 pages) $6.00**

Corporate Reorganizations



— Their Federal Tax Status

By **ROBERT S. HOLZMAN,** *Schenley Distillers Corp.*

CLARIFIES voluntary or compulsory reorganization process, with emphasis on protecting tax-free characteristics. Shows how reorganization may solve many corporate problems; what courts will and won't allow; what taxpayer must do. Says THE NEW YORK C.P.A.: "*. . . much-needed discriminatory analysis and comment on this difficult and technical subject — of valuable assistance to practitioners of taxation.*"

(411 pages) $7.50

Accountants' Handbook

Editor, **W. A. PATON, C.P.A.,** *Professor of Accounting, University of Michigan; 90 Assisting Editors*

LAST WORD in accepted principles and procedure over the entire range of commercial and financial accounting. Gives you in compact, easy-to-find form working methods, systems and controls on every part and particle of accounting. Handbook helps you develop skill that puts you years ahead in experience; helps you make prompt, practical, on-the-spot decisions. Board of 90 contributing and consulting editors gives stamp of highest authority. Hundreds of illustrations.

(1505 pages) $7.50

Mail This Order Today →

JUST ISSUED: AUDITING

By **THOMAS W. BYRNES, C.P.A.,** *formerly Associate Professor of Accounting, Columbia University;* **K. LANNEAU BAKER, C.P.A.,** *formerly Lecturer in Accounting, Columbia University;* **C. AUBREY SMITH, C.P.A.,** *Professor of Accounting, University of Texas*

PRESENTS AUDITING as a separate, essential component in the field of professional accounting. To the man entering the profession, this text provides a practical knowledge of present-day auditing principles, procedures, and techniques. The practitioner will find it useful as a guidebook, refresher, and manual for staff training.

For each item on the balance sheet, and for the major profit and loss items, a specific, detailed audit program is set forth from the viewpoint of currently accepted auditing standards. Drawing upon their broad experience, the authors present abundant illustrative material to visualize the suggested procedures, and to aid in determining which of the many techniques oftentimes available should be used in a given instance. Includes correlated questions and problems. **(738 pages) $6.00**

CONTENTS: Field of Public Accounting. Organization of Public Accountant's Practice. Planning and Beginning Audit. Internal Control—Cash, Purchases, Sales, Securities, Fixed Assets, Liabilities. Audit of General Records. Currency and Stamp Funds. General Cash. Notes, Accounts Receivable. Inventories—Methods of Valuation, Audit Procedure. Investments. Fixed Assets—Land, Buildings. Machinery, Equipment; Furniture, Fixtures. Intangible and Wasting Assets. Prepaid Expenses, Deferred Charges. Notes, Accounts Payable. Other Short-Term Liabilities. Long-Term Debt, Liability Certificate. Proprietorship—Capital, Capital Stock, Surplus, Surplus Reserves, Secret Reserves. Profit and Loss Accounts; Closing the Audit. Auditors' Reports. Special Investigations, Audit Techniques, Auditing Standards. Ethics, Duties, Responsibilities of Auditors.

Business Budgeting and Control

By **J. BROOKS HECKERT, C.P.A.,** *Associate Professor of Accounting, Ohio State University*

GUIDANCE in preparing, operating budgets for any size or kind of business. How to forecast trends, plan ahead. Tested methods readily applied to your own situations. 84 form facsimiles; 25 sample budgets. Says CONTROLLER: "*Good discussion of flexible budgets, fixed and variable costs — basic problems under any type budget.*"

(546 pages) $5.00

The Ronald Press Co., 15 East 26th St., New York

SEND me books checked below. Within 5 days I will either remit price, plus postage, or return the books.

☐ C.P.A. Law Questions & Answers, Teevan	$6.00
☐ Corporate Reorganizations, Holzman	7.50
☐ Business Budgeting and Control, Heckert	5.00
☐ Auditing, Byrnes, Baker & Smith	6.00
☐ Accountants' Handbook, Paton	7.50

M 394

Name............ *(Please print)*

Firm............

Address............

City............Zone............State............

The Ronald Press Company

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

The matters contained in this publication, unless otherwise stated, are the statements and opinions of the authors of the articles, and are not promulgations by the Society.

VOL. XVIII *November • 1948* No. 11

Inventory Disclosures

By A. C. LITTLETON, C.P.A.

THE trend of the discussion of inventory pricing seems to be toward a gradual resolution of some of the problems of inventory theory. Possibly in time inventory valuation reserves will replace the traditional cost-or-market rule. The way has been clearly opened for this development by the reasoning that a deduction reported in both the balance sheet and the income statement could hardly be considered objectionable if the accountant believed the information significant and the method informative.[1]

If the reserve treatment becomes widely accepted and generally used, the outcome may be viewed with satisfaction for two reasons. The reporting of inventories will then have been brought up to the same level of informative disclosure that has long been customary for accounts receivable and for fixed assets. The sole justification for deducting these reserves is better disclosure of enterprise information to the reader of both financial statements. Better disclosure of inventory information would also result from the use of deducted reserves.

A. C. LITTLETON, Ph.D., C.P.A., is Professor of Accounting at the University of Illinois. He is a member of the Illinois Society of Certified Public Accountants and of the American Institute of Accountants, and has held various offices in the American Accounting Association, including that of President and of Editor of the *Accounting Review*.

The second reason for satisfaction is that accounting logic will then replace a rule that came to be a traditional habit of thought about inventory pricing.[2] The reserve method is logical for a simple and convincing reason. The accounting purpose of financial statements is to aid the reader to understand a given business enterprise. Financial statements have accomplished that objective in reporting receivables and fixed assets; they could easily be made to reflect the same logical relation between informative disclosure and valuation reserves in connection with inventory also.

It is not stressed often in the literature that most accounting methods are at once utilitarian and logical. This is an important element of strength. Without having a logical (rational and reasonable) relationship to accounting objectives, a given practice is only utilitarian. But nearly all accounting methods are logical as well as useful;

[1] "Inventory Reserves", Carman G. Blough, in *The Illinois Certified Public Accountant;* March, 1948.

[2] "If one accounting method is more logical and more useful than another, it should be generally adopted, though it fly in the face of tradition". From an editorial in the *Journal of Accountancy,* April, 1948.

the cost-or-market rule is the outstanding example of an exception. Accounting needs the union of the logical and the useful here. An improved disclosure of inventory data, therefore, would remove a spot of illogic that has been in financial statements as long as inventory has been reported at a net figure because of price changes.

Are the problems of inventory pricing all solved when inventory valuation reserves are clearly disclosed in the balance sheet and the income statement? Even if this reporting method is fully acceptable, a problem still remains since the calculation of the reserve has yet to be fully explored. There still is a question about the effective similarity or difference between (a) physical deterioration (loss, damage, depreciation of goods), (b) market deterioriation (shifting demand, obsolete goods, substitute products), and (c) price level changes (fluctuations in the volume of money, managed currency).

All three causes are mingled whenever inventories are shown at net figures. Will all three continue to be mingled in the calculation of the reserve deduction? Will this produce the best disclosure, or do some causes suggest direct inventory adjustments while others seem better treated by a reserve?

(a) If goods are known to be lost, stolen, destroyed, should these be written off by credits direct to inventory, or should they be the basis for a reserve? (b) If goods are somewhat damaged or shopworn, and if the resulting market deterioriation (customer opinion) makes recovery of invested cost problematical, should an amount be written off or reserved? (c) If price level changes have occurred outside of the enterprise's own transactions, should the treatment call for write-off or reserve?

The first situation does not raise an accounting problem. The loss is objectively and positively determined; no part of the investment is recoverable; direct write-off is as appropriate as that for a specific debt known to be uncollectible.

As to the other two situations there may be unsettled doubts. Are the two situations alike? If market deterioration and outside price changes are alike they should produce the same accounting treatment; if they are unlike they probably should receive different treatment in order to reflect that unlikeness in the accounting statements.

They are alike in the fact that marketing experience and judgment are needed to appraise the significance of each.

They are unlike in two particulars: (1) in the fact that market deterioration (salability) is judged from a study of goods now in enterprise possession and from the reactions of enterprise customers to the goods possessed. Here inventory pricing is a matter of repricing, of marking the goods to move them even if less profit, or no profit, results—of releasing prior investment for profitable reinvestment in more promising kinds of goods. That, however, is not the same problem as the one posed by price level change.

And (2) they are unlike in the fact that price fall is judged from a study of events outside of the enterprise. Although outside price data are sometimes definite and obtainable—and therefore seem clearly objective—judgments resting on this basis are in fact less realistic than are judgments on the apparently less objective basis of observed market deterioration. For, in most cases, outside prices ("the market") are not easily determined by trustworthy samples, especially since the goods now on the shelf may not be replaced at all, other goods with better prospects being preferred. Furthermore, there is a large difference in "responsiveness" as between changes in sales prices and changes in purchase prices for different lines and at different times. If sales prices, for example, are not responsive to purchase market changes, the reasonableness of attributing an immediate loss to present in-

ventory is thin indeed. As a third point, judging inventory by outside price changes tends to make a formula of market price ("the lower of cost or market applies item by item"). And the use of a formula tends to generate a habitual or routine action, that is, a treatment according to rule rather than under the guidance of a real analysis of the variables in the given situation.

It appears therefore that in some ways it might be a more useful disclosure to the reader of financial statements if price level change were the only cause he would be expected to read into a deducted inventory reserve. The reader, of course, would have to be directed by accepted practices to know that all other causes operating on inventory pricing would produce direct adjustments before the account entered the accounting statements. His understanding of management's message in the two financial statements would be improved by thus linking these inventory valuation reserve disclosures solely to the fact of fluctuating outside prices.

The deterrent to adding this restriction to the proposed modernization of inventory accounting by the use of valuation reserves would be the theory that change in outside price level is a symptom of market deterioration (salability) just as much as are observed customer reactions (not buying the offered goods). If this theory stands, it would link the two causes closely enough to justify using both in determining the deduction reserve; or if both are used in determining the reserve, this theory is the one underlying the action. The preferred solution of the reserve calculation problem ought to give primary consideration to reader understanding, including if necessary a campaign of reader education regarding the purpose that public accountants have in adopting a certain preferred method of calculation.

The professional man could increase his prestige by maintaining a research attitude of mind toward inventory policy. For each client's inventory is a research problem to the independent auditor, one that is unlikely to be well solved by any kind of stock formula. Price responsiveness is always an individual situation; the factual bases of the judgment of the client's marketing man regarding the marketing situation, present and prospective, should be appraised; the client's established policy of repricing to move goods and to release unproductive investment should be examined. All of these are essential parts of the basis for the professional accountant's opinion regarding inventory disclosures. A decreased reliance on a formula, coupled with a spirit of investigation consciously brought into the field by high-level staff men, is likely to prove more satisfactory than the same auditing cost spread over more man-hours devoted to figure checking by less experienced men.

A research attitude of mind probably already influences many public accountants in many situations. And as they look for new outlets to express this attitude, the study of inventories will undoubtedly be recognized as another such situation, with the result of further improving accounting statement disclosures.

Perhaps the research approach may also help to clarify the concepts underlying such phrases as "useful cost", "normal profit", for in a sense these terms are like another formula. Useful for what? What is normal? Several answers are possible and some of them may indicate why the phrases are not very appropriate to accounting.

"Useful cost" might seem to refer to the usefulness that inventory items have for buyers. Would falling sales prices then be presumed to indicate decreased buyer interest, or competition with alternative goods, a change in the buyers' type of operations, his decreased purchasing power thus passed on? Or the phrase could refer to usefulness of inventory to the seller as a means of attracting buyers and revenue. The offering prices attached to

inventories are bids for customers. If the bids are not accepted by customers, the profit possibilities to the holder evaporate. This would result in a successive lowering of offering price until the goods are moved, perhaps with unquestioned losses. This action is "pricing", a phase of selling; it is not accounting action, a phase of profit calculation. No amount of accounting adjustments or of price-tag changes can "make" a profit or a loss. We only use accounting to calculate as best we can a result already present in the non-accounting situation.

Inventory is useful to the holder in two ways: (1) as physical goods to attract customers and thus to derive revenue, and (2) as a measured amount of investment, the figures of which are useful primarily because they must be known before any calculation of merchandise profit or loss can be made. Inventories, as physical goods, have no usefulness for accounting; inventories have accounting usefulness only in terms of investment dollars, only as costs representing an effort to produce revenue.

The cost-or-market rule directs that investment figures be modified so they will thereafter represent "useful cost". Is that kind of "usefulness" an unbiased view? Is it not a "manipulated" use, a way of trying to show merchandising results—"normal profits"—by changing book figures? If we are doubtful about the salability of goods because of suspected deterioration or obsolescence, why not use the technique now applied to doubtful accounts receivable and transfer the suspect inventory items to "doubtful goods" account? This in effect is just what a deducted inventory reserve would indicate, without the bookkeeping formality of item segregation in the ledger. No doctrines of "useful costs" or "normal profit" are needed. This accounting action is a simple earmarking of suspect items to await the decisive turn of events.

When deterioration or obsolescence are demonstrably present, and the loss is complete and positive, the items need not wait in the status of "doubtful goods". When only a price level change is involved, the situation is different, for the investment adventured is still adventured, the outcome is still uncertain. At the moment a loss is pure hypothesis; it represents a theory or belief resting not on the goods possessed but on outside information about goods not possessed, goods which may never be bought. A loss that in reality is only surmise is, under the old pricing rule, treated as an indisputable fact. Surely surmise is a cue for indicating suspended judgment, that is, for using a deducted reserve rather than direct write-off.

The reserve treatment is therefore essential for price level changes at least. In deciding whether estimated physical damage and marketing deterioration should join price change in the reserve, the principal factors to be weighed against each other are the expediency of joining the two versus the essential dissimilarity of the two causes.

Fringe Labor Costs in the Apparel Industries

By Jack Friedman, C.P.A.

Most of us recall the days prior to 1936 when our concept of labor costs envisioned only moneys paid to workers for productive services. Today the labor account resembles a mother hen surrounded by a brood of chicks, the latter represented by payroll taxes and a host of union welfare payments that vary in direct ratio with the dollar of labor paid. For want of a better term, these appendages have come to be known as "Fringe Labor Costs".

Management, as well as the accounting profession, first became aware of the advent of fringe costs in 1936, and later, when the Federal Old Age Benefit and the Federal and State Unemployment tax laws become effective. During the early 1940's the International Ladies Garment Workers Union and the Amalgamated Clothing Workers of America pioneered among all unions in obtaining for their members new benefits in the form of Health Funds, Paid Vacation Funds, Paid Holiday Funds, and Retirement Funds, all at the expense of the employer.

The advent of these welfare payments, which are completely predicated upon the amount paid for direct labor, has imposed a substantial burden upon the apparel manufacturer both from the standpoint of their absorption into the cost structure, and by reason of the extensive record keeping and reporting involved.

Jack Friedman, C.P.A., received his accounting education at New York University where he was elected to Delta Mu Delta, honorary scholarship society. He has served on the Clothing Manufacturing Accounting Committee of the Society on many occasions since 1935, and is at present the Chairman of that Committee.

Mr. Friedman is a partner in a prominent New York firm of Certified Public Accountants, specializing in apparel accounting.

This paper was recently presented by him at a technical meeting of the Society, conducted by the Committee on Clothing Manufacturing Accounting, at the Engineering Auditorium.

It has been the writer's experience that management in the garment industries, particularly among the smaller firms, has not paid sufficient attention to the fringes attaching to their labor costs. The nature of the apparel industries is such that pre-estimates of new styles, generally known as "calculations", must be prepared before it is determined whether the item can be profitably manufactured and sold at a given price. When the estimate is made, due consideration must be given to each element of cost, and while variations inevitably occur later in the mass production, due to shifting raw material and labor costs and other elements, it is certainly necessary to make adequate provision for the labor fringes if the results are to follow the estimates.

In stressing a point, it is customary to cite a "horrible example". A low-end women's coat manufacturer of our acquaintance found recently that his gross profit for the month of February, 1948, was inordinately low. His sales volume was adequate, and mark-down sales were inconsequential. Opening and closing inventories were found to be correct and all accruals duly made. Recognition was given to the fact that his price line had been lowered in an effort to maintain volume in the face of falling demand, and that his anticipated gross profit was much lower than usual. The fault, therefore, probably lay in his calculated costs as compared with the actual cost.

Scrutiny of the "calculations" for February, 1948, revealed that fringe labor costs had been estimated at the equivalent of 5% of direct labor. The same percentage had been used during all the war and post-war years. Analysis disclosed that the proper fringe cost percentage should have been approximately 13%. The additional 8% of direct labor represented close to $3,000 of "missing" gross profit.

When these facts were called to his attention, the manufacturer stated that he had never paid much heed to the actual fringe costs, and that the oversight had meant little during the recent prosperous years. He was emphatic, though, in stating that the correct fringe figures would be used in the future.

The apparel industry is composed of many different branches but, in the interest of brevity, our study of fringe costs was limited to those applicable to the following three major segments thereof. These represent most of the concerns in the field:

1. Ladies' coats and suits
2. Men's and boys' clothing
3. Dresses

Ladies' Coat and Suit Industry

In the ladies' coat and suit industry there are two welfare funds to which contributions are made:

1. Retirement Fund
2. Health and Vacation Fund

The Retirement Fund, as its name implies, is an adjunct to the Federal Social Security program, and its purpose is the payment of pensions to eligible workers at age 65. Contributions to the Retirement Fund are made at the rate of 3% of gross wages paid to employees in the manufacturer's "inside" shop, and 2.25% of the contractor's billing price for "outside" labor. The differential allows for the contractor's overhead and profit margin, computed at 25% of the billing price.

The Health and Vacation Fund is likewise self-explanatory. Contributions are made at the rate of 3.5% of payrolls for the inside shop and 2.625% of contractor's billings.

In addition, hidden fringe cost factors are present in the ladies' coat and suit industry. Week workers are paid at regular rates for 7 holidays per year, and piece workers receive an amount equal to one-fifth of the recent wage increase which was stated in dollars rather than units of production, for each holiday week. Overtime for piece workers during holiday weeks is computed at time and one-half after 28 hours. National Coat and Suit Recovery Board labels are required for each garment produced, and almost invariably an additional assesment for the under-purchase of labels is levied against each manufacturer. Since holiday pay and the cost of labels are nonproductive, they represent a hidden factor in the cost structure, and should be computed at a minimum of 3% of direct labor.

To round out the fringe picture, consideration must be given to the Federal Old Age Benefit Tax, and the Federal and State Unemployment Insurance taxes, which likewise are imposed upon payrolls. It is difficult to determine an exact percentage for the State unemployment insurance rates owing to the differences arising from Merit Ratings and variations in the rates of different States. However, the combined burden of Payroll taxes is generally 3% of direct labor and in many cases 4%. Compensation insurance premiums on labor also constitute a hidden fringe cost. It appears, therefore, that fringe labor costs in the ladies' coat and suit industry should be computed at a minimum of 13% of direct labor, analyzed as follows:

	%
Retirement Fund	3.0
Health and Vacation Fund	3.5
Holidays and Labels	3.0
Payroll Taxes	3.5
Total	13.0

Men's and Boys' Clothing Industry

In the men's and boys' clothing field similar welfare funds are in effect pursuant to joint agreements. For an inside shop, the manufacturer pays a consolidated rate of 5% of unionized direct labor to cover Retirement and Health Insurance Funds. In addition, two weeks of vacations with pay are given to union employees who have worked for the employer one year or more. Six paid holidays are given to each union employee. The effective cost of vacations and holidays for the inside shop is approximately 6.5% of direct labor.

Where an outside contractor is employed, a flat rate of 11.30% of the contractor's gross invoice is added to cover all welfare funds and payroll taxes. Converting the rate of 11.30% of gross billing to a direct labor basis, we find that it approximates 15%, which is comparable to the inside shop rate. The fringe labor cost for the men's and boys' industry should be estimated at 15%, analyzed as follows:

	%
Retirement and Health Fund	5.0
Vacations and Holidays	6.5
Payroll Taxes	3.5
Total	15.0

The agreement with the Amalgamated Union provides that if a surplus remains in the Vacation and Holiday Fund after all disbursements are made, it is to be returned to the contributing members pro-rata. Here at least is one ray of hope for the clothing manufacturer.

Dress Industry

The dress industry carries the lowest percentage rate of fringe labor cost, but this is small comfort to the dress manufacturer since the ratio of direct labor to selling price is relatively higher in this industry.

For an inside shop, the sole welfare contribution is 4.5% of union payrolls. In addition, paid holidays are given to union workers employed on a week-work basis. Piece workers are not paid for holidays, but their overtime starts after 28 hours in a holiday week.

Varying rates are applied to contractors' invoices in the case of the outside shop. The contractor's billing price for labor on dresses selling up to $6.74 is assessed at the rate of 3.46% for the welfare fund. The contractor's billing price of labor for dresses selling between $6.75 and $16.74 is taxed at 3.33% and for dresses above $16.74 at 3.21%.

The union employs the funds collected in this industry approximately 78% for vacation and health benefits and 22% for retirement benefits.

The effective burden on direct labor for fringe costs in the dress industry is approximately between 9% and 10% depending upon the pay basis of the shop, analyzed as follows:

	%
Retirement, Health and Vacation Funds	4.5
Holidays estimated at	1.5
Payroll Taxes	3.5
Total	9.5

Conclusion

Present trends in labor-management relationships indicate that fringe costs will increase in the future. Witness the recent establishment of a Designers' Health and Welfare Fund, which carries the fringe angle into the field of indirect costs.

The accountant has a twofold duty with respect to fringe labor costs in the apparel industries. In the first place, he should discuss them in detail with his client, and make certain that they are adequately provided for in cost calculations. Secondly, in the preparation of monthly reports or periodic certified statements, his audit should include a check to determine if all fringe costs have been fully paid for or accrued.

More accurate financial reporting will result.

Some Notes on the Audit of Textile Accounts

By NATHAN FEINBERG, C.P.A.

THE field of textile accounting is very broad. There are many kinds of fabrics and the operations in their production are numerous. The kind of cloths manufactured are either woven or knitted and may be divided into the following classes: silk, cotton, rayon, wool, lastex and mixtures of certain of these items.

A single organization may be engaged in one, several or all of the operations required to produce finished goods. During the last few years we have heard much of the vertical integration of organizations in which separate companies perform one or more of the operations, and in which the ownership of all of the companies needed to produce the merchandise is controlled by one group.

I shall confine this discussion to a unit which purchases rayon yarn, weaves it into greige goods, and then dyes and finishes it. The operations of a converter include only the purchase of greige goods and then the dyeing and finishing of it.

I will touch upon the procedure for a periodic audit of the books and records of both such units. Generally speaking, the audit procedure in any manufacturing field may be used to advantage in the audit of a textile manufacturing company. The audit of a textile converter includes the same major steps as required for a textile mill. Of course, the former is simpler because there are no manufacturing operations, textile machinery, or heavy fixed assets to be concerned with.

The extent of a test audit and its attendant methods of sampling need no discussion here. Likewise, I shall omit commenting upon the bookkeeping system and internal check or control, which are assumed to be adequate.

The checking of cash on hand and in banks, reconciliation of schedules of subsidiary ledgers, ageing of accounts receivable, verification of assets and liabilities with outside sources, scrutiny of journal entries, footings of books of original entry, checking of general ledger postings, vouching of purchases and payments, preparation of adjustments, and the other customary steps in an audit are, of course, to be performed as usual, according to the judgment of the auditor.

It is now desirable to bring to your attention those audit steps which may be said to be peculiar to the textile industry.

NATHAN FEINBERG, C.P.A., has been a member of our Society since 1928. He is the past Chairman of the Committee on Textile Accounting and a member of the Membership Committee of the Society. He is a partner of the firm of Feinberg & Spaulder, C.P.A's., of New York City.

This paper was presented by him at a technical meeting recently conducted by the Society's Committee on Textile Accounting, at the Engineering Auditorium.

Factoring

At the outset, it must be said that this industry lends itself to factoring, and that merchandise inventories are very heavy and need great attention from the auditor. Factoring contracts, if any, should be examined. Factor's monthly statements should be checked and compared with the books and confirmed with the factor as of the balance sheet date.

Verify whether all returns have been entered and reported to the factor. A list of claims and disputes should be made. A list of department risk accounts should be made. The last two items should be footnoted on the balance sheet.

Merchandise Inventories

A textile mill audit sometimes requires that the auditor works out clearances. This requires some technical knowledge of textiles and means that the correct or approximate yardage of greige goods cloth has been produced on the looms from the known weight of the warp and filling yarn used in the lot or contract, and depends upon the construction of the cloth produced. Since these clearances account for the yarn, it is a simple matter to verify the amount which remains in the inventory, either in the raw or on the looms.

The next step is to check the manufacturing orders to the inventory book or sheets. A greige goods book usually shows the entry of the completed greige goods and the piece number assigned to each piece and the yardage. This record is often combined with a finished goods record, which shows the pieces in the course of dyeing and finishing. When this operation has been completed, the new number of the piece and the new yardage are recorded, as shrinkage has taken place. The sales slips should also be test-checked to this book. Piece numbers and yardage are readily identifiable. This record is of great value in checking the inventory of greige and finished goods.

Other audit steps include: Test or make actual count, if necessary, of quantities on premises. Age the inventory. Confirm quantities located outside of the premises. Verify existence of bales, wherever located. Check mathematical computations. Test unit prices of all component items of inventory. Inquire as to method of pricing.

It is a common error, in estimating the cost per yard, to add 10% or an estimated allowance for shrinkage in the dyeing and finishing process to the cost of yarn and labor per yard. The correct way of determining this is by dividing into the cost, the residual percentage. There then should be added the dyeing and finishing charge per yard and also the estimated manufacturing overhead per yard chargeable to cost.

Receiving Records

It is especially wise to examine the receiving records. This may disclose sales returns not entered or not reported to factors, as well as purchases of yarns or greige goods withheld from the purchase book for the period under audit.

Fixed Assets

In connection with the audit of the fixed assets, determine that no depreciation is being taken on old looms and machinery which have been fully depreciated.

Commitment or Contract Book

Commitments are among the first items that a banker or credit grantor looks for today. The commitment or contract book and copies of unfilled contracts should be examined. Reports should show the status of unfilled commitments and contracts for purchases of yarn and greige goods.

Trade papers may be used to verify market values of the merchandise under commitment for future purchases and delivery and can be used to check inventory prices. Also inquire into commitments for new machinery and commodity futures for cotton and wool, if mixtures are made.

Gross Profit Percentages

Manufacturing gross profits should be compared percentage-wise with other concerns in comparable situations. During O.P.A. control days, this was an easy matter, as all prices were subject to regulation. However, it is much more difficult to make comparisons now, due to the many factors that enter into the industry.

If the gross profit appears too small, make appropriate inquiry. It may be necessary to analyze the elements of cost per yard into yarn, labor, dyeing and finishing, and plant overhead in order to satisfy the auditor as to the correctness of the gross profit percentage.

Clearance Accounting for Textile Weavers and Converters

By SIDNEY C. FRIED, C.P.A.

TO THE uninitiated, the textile industry in this country may not appear as dramatic or as glamorous as some of our other industries, but in actual size and importance it rates in the number two position. The food industry, alone, can lay claim to being larger—or more important.

The ramifications of the textile industry are almost without end. The field is vast. Consumers spend 20 billions a year for its merchandise. Over two million American men and women find employment within its structure. Thousands of business firms devote their energies to the efficient management of its myriad problems. It is a fascinating mixture of science, industry, and art. It has brought its products within the economic reach of all classes of Americans and has made them the best clothed people in the world. The textile industry stands as a monument of achievement to our competitive, individual enterprise system.

The primary subdivisions of textiles are, of course, cotton, rayon, wool and silk. The cotton division accounts for almost 75% of the total textile production, handling some five billion pounds of fibre. Rayon, despite its youth, has grown to second place and now produces approximately one billion pounds of fibre a year, representing some 15% of the total. Wool comes third with a 700 million pound production, being 10% of total. Silk has less than 1% and only consumes about two million pounds yearly.

As I am most familiar with the rayon industry, I shall refer to it primarily in the ensuing discussion. However, most of the principles involved are generally applicable to the other fibres as well.

The rayon textile industry includes the yarn manufacturers, the mills, the processors, and the converters. Of course, as you know, many textile concerns have integrated vertically in recent years and their activities cover two or more phases of the industry.

The accounting system of a textile weaver and converter is a rather broad subject, one to which we might well devote a good many evenings instead of twenty minutes. However, rather than to spread ourselves thin and discuss this matter from the usual accounting systems point of view, I feel it would be more advisable to concentrate on that phase of the subject which is peculiar to the textile industry—namely, accounting for the product itself. I'm sure you are not overly interested in how many columns we have in some of our ledger records, or in the rulings on our forms, but I do think that a discussion of the methods used to control the product as it moves through the manufacturing process

SIDNEY C. FRIED, C.P.A., has been a member of the Society since 1940 and is currently serving on our Committee for Textile Accounting. He is actively engaged in the Textile Industry as Comptroller for the Martin Weiner Corp., integrated rayon manufacturers. He is also a member of the Controllers Institute of America.

This paper was presented by him at a technical meeting of the Society recently conducted at the Engineering Auditorium, under the auspices of the Committee on Textile Accounting.

would be more to the point. Most of the general accounting records are the standard ones we find in most industries; however, the unique element of the textile industry is, of course, the product itself and I have, accordingly, confined this paper to this phase of the problem.

As you know, rayon yarn is a chemically synthesized product made from wood pulp or from cotton linters. The yarn is delivered on cones by the yarn manufacturer to the mill door. Needless to say, it is fundamental that proper procedures be in effect for receiving, checking, marking, storing and recording the yarn.

Rayon yarns are differentiated and designated by a system of numbers that expresses the relationship existing between the length and weight of the yarn. This system dates back to the early silk days in Lyons, France, during the middle 1800's. In those days, in order to test silk for size, a certain length of yarn was placed on one scale pan of a balance. On the other scale pan were placed small copper coins called Deniers. The number of coins required to balance the yarn designated the size of the yarn in Deniers. Today we know our rayon yarns by the terms 100 Denier yarn, 150 Denier yarn, etc.

Now let us assume that the yarn manufacturer shipped our mill 100,000 pounds of 100 Denier yarn and that we must exercise accounting control over the proper utilization of this material. The first thing we must know, of course, is the process of manufacture through which it will pass. Briefly, and in highly simplified form, the following are the operations of a weaving mill:

1. *Warping Department:* In this operation, the single filaments of yarn are taken from the cone and arranged in a continuous wide sheet of yarns, in which the filaments are spaced equally apart, lie parallel to each other and are in the same horizontal plane. "Warp", as you know, is the term used to designate the lengthwise yarns in a piece of fabric.
2. *Sizing Operation:* In preparation for weaving, it is necessary to first size, or slash, the warp. This is accomplished by passing the warp through a gelatinous solution and then over a series of dry cans where a moderate stretch is imparted to the yarns. The purpose of impregnating the yarn with the sizing solution is to increase its strength and minimize breakage due to chafing on the loom. A sizing gain of about 5% in the length of the warp is generally effected during this operation.
3. *Quilling:* This is the operation in which yarn from cones is transferred to quills in preparation for use as filling in the weaving process. The term "Filling" designates the cross-wise yarns in a fabric.
4. *Weaving:* This is the actual operation of interlacing the two sets of yarns, one running lengthwise and called the warp, and the other running crosswise and termed filling. The yarns interlace each other at right angles in a desired pattern. The quills containing the filling move back and forth through the warp at a pace of 150 times a minute. The woven fabric is wound up on a wooden roll and when 100 yards is accumulated, it is cut off, creating what is known as a "piece". Each piece is identified with a number. The natural operation of a loom in weaving a fabric creates a certain "take-up" or "crimp" in the warp that may run as high as 8 to 10%. Woven fabric taken off the loom is termed "greige goods" and is ready for shipment to the mill's customers.

This is, of course, an over-simplified version of a weave shed operation and tendered in the interests of clarity.

Now that we have a general idea of the manufacturing processes, let us proceed to exercise some of our accounting controls. This is accomplished by a set of arithmetical calculations known as a "Clearance". For purposes of our clearance, let us assume the following situation: The mill's only receipt of yarn during the month, was the 100,000 pounds of 100 Denier yarn, which we mentioned before; the mill had no inventory at the beginning of the month; it wove only one quality of fabric which we shall say is constructed of 4000 ends of 100 Denier warp and 3000 picks of 100 Denier filling per square yard; by the end of the month the mill produced 200,000 yards of greige goods

which it shipped to its accounts; the inventory at the end of the month consisted of 2,000 woven yards on the looms, 52,500 warp yards sized, 50,000 warp yards unsized, and 58,800 pounds of 100 Denier raw yarn stock; and finally, that the sizing gain was 5%, the weaving crimp 5%, filling and warp waste 2% each.

The object of the clearance calculation is to account for all the yarn from the time it is received to the time it is shipped, to see that the yarn was transformed into fabric according to construction formula, that there was no excess wastage or damage, and that the final inventory is accurate for all practical purposes. We proceed as follows:

1. Inventory at beginning of month	—0—
2. Yarn received — 100 Denier	100,000 lbs.
3. Total yarn to be accounted for	100,000 lbs.

4. Yarn consumed during the month — 200,000 yards of fabric. Now we must translate from yards of fabric back to pounds of yarn. To do so we use the following formulas:

   (a) Warp: $\frac{4000 \times 1.02}{44645} =$ .091 lbs. of warp per yard of fabric

   A word of explanation as to the derivation of this formula:
   A one yard length of woven fabric with a warp of 4000 ends will obviously contain 4000 yards of warp yarn. Now we are dealing with a woven yard of cloth here — and we must remember that our warp experienced a 5% stretch in the sizing department, and also a 5% take-up in the weaving department before it reached the woven stage. In actual practice, adjustments are necessary for these factors, but for our purposes here, I have assumed that one offsets the other. That leaves us with the final adjusting element, namely the 2% warp waste incurred during the manufacturing process. We allow for this by multiplying our 4000 yards of warp yarn by 1.02.

   The denominator of our fraction, 44,645 is the number of yards in 1 pound of 100 Denier yarn.

   (b) Filling $\frac{3000 \times 1.02}{44645} =$ .068 lbs. of filling per yard of fabric

   (c) There are: .159 lbs. of yarn in 1 yard of fabric (.091 + .068)

   (d) 200,000 woven yards x .159 = 31,800 lbs. of yarn consumed

5. Final yarn Inventory should be 100,000 lbs., less the 31,800 lbs. consumed, or 68,200 lbs.

6. In order to check this 68,200 figure, we have next to reduce the entire actual physical inventory at the end of the month to pounds of yarn. We do so as follows:

   (a) 2,000 yards woven on looms will equal 318 lbs. of yarn calculated as before mentioned.

   (b) 52,500 yards of sized warp must be adjusted for the sizing gain of 5% by dividing by 105 to arrive at 50,000 original warp yards. Using the pounds per yard of warp calculated above, we find 50,000 yards x .091 = 4,550 pounds of yarn.

   (c) 50,000 lbs. of unsized warp will likewise equal 4,550 pounds of yarn.

   (d) We therefore have:

	318 lbs.
	4,550 lbs.
	4,550 lbs.
Plus final raw yarn of	58,800 lbs.
Total	68,218 lbs.

7. The actual physical inventory of 68,218 pounds of yarn compares with a calculated inventory of 68,200 pounds, which is close enough for our purposes, and we have effected our control over the product. We have accounted for the yarn from its receipt through the various stages of manufacture, to its final shipment out of the mill as greige goods.

The clearance calculation presented above has been pared to the bare essentials for purposes of illustration. However, in actual practice the problem is far more complex. An active mill may run anywhere from 10 to 50 or more different qualities of fabric. Each quality, in itself, may present an intricate construction problem. Plied yarn fabrics, blended fabrics, and such are highly complex in structure and present a neat clearance problem. However difficult these calculations may become, they are very much worth while as they afford just about the finest control a front office can have over its operating plants.

Let us follow now, the 200,000 yards of greige goods shipped by our mill. This merchandise was bought by a converter who ordered it sent directly to his processor. The converter instructs this processor precisely as to how he wants this fabric dyed, printed and finished. On completion, the merchandise may be shipped either to the converter or directly to the converter's customer, according to the converter's instructions.

It is necessary for the converter to exercise accounting control over the 200,000 yards of greige goods from the time of purchase through the final sale. This he accomplishes by two clearance calculations as follows:

1. *Greige goods clearance*— This is merely an arithmetical calculation to see that the finished goods received by the converter accounts for all the 200,000 greige yards less allowable shrinkage.
2. *A finished goods clearance* to determine that the converter's finished goods stock at the beginning of a period, plus his receipts, less his sales, agrees with his closing inventory.

This calculation must be made for each quality of fabric that the converter handles. Provision must also be made for sales returns, samples, damaged goods, differences between the yardage recorded on the tag of the piece of fabric and the actual measured yardage.

Maintenance as a Factor in Determining Depreciation for Motor Carrier Equipment

By Nathaniel L. Fish, C.P.A.

The motor carrier operation has recently emerged from its swaddling clothes and has joined the ranks of the country's major industries. It covers the transporation of property and passengers over every possible highway or road reaching out to the cities, towns and villages in every state in the United States.

Many of the motor carriers who pioneered the field a decade or two ago have developed into major operations. We find "property carriers" operating fleets of trucks, tractors and trailers over regular franchised routes aggregating hundreds and thousands of route miles. The motor passenger carriers have kept pace and have developed large bus systems, serving every municipality in the country and replacing both the fast disappearing trolley car systems and many railroad routes.

The bus, truck, tractor and trailer are considered the operating units in this industry. Maintenance costs and depreciation charges are not only construed as major components in the cost of the operation; but its proper analysis, determination and interpretation will materially assist in the successful development and continuation of the carrier's operations. A correct analysis of these costs will enable the carrier to secure the approval from the Commission having jurisdiction over it, of a tarriff rate that will permit it to operate at a true profit, which is the ultimate aim of every business executive.

Nathaniel L. Fish holds the C.P.A. certificate from the States of New York and New Jersey. He is also a duly authorized I.C.C. Practitioner.

Mr. Fish is the senior partner of N. L. Fish & Company, C.P.A's., and is Secretary and Treasurer of New Jersey Motor Bus Association, Inc.

This paper was presented by him at a technical meeting of the Society, recently conducted under the auspices of the Committee on Land Transport Accounting.

Maintenance and depreciation are interlocking factors in the operation of a motor vehicle. Together they represent the direct cost to the carrier for the use of the vehicle. The depreciation charge represents, in dollars and cents, the reduction in the useful operating value of the vehicle due primarily to the wear and tear of the integral units, parts, accessories and structural frame. Maintenance represents the cost or value of the material consumed in replacement of parts plus the mechanical labor and kindred services involved in making the necessary repairs and replacements. The interdependence of these factors, depreciation and maintenance, has been widely recognized. Maintenance not only affects but is affected by depreciation. Maintenance costs are governed and measurable by the extent to which the useful life of the various units and parts making up the vehicle has already been curtailed—that is, by the depreciation which has already taken place.

Recognition of this fact, it is submitted, requires a revision of the traditional methods of computing depreciation, at least with respect to such items of property as buses, trucks and similar vehicles. Neither the mileage basis nor the straight line basis, which are the methods most commonly used today, reflect the true costs applicable to any particular period. In other words, it is submitted that the impact of depreciation upon maintenance costs should be

reflected in the depreciation charge and that present methods of computing depreciation, in conjunction with the practice of including in the operating costs for any particular period only the maintenance costs actually paid or accrued durng the period, do not reflect the true cost of operating the vehicle for that period.

Most progressive carriers today keep mileage and maintenance records for each individual vehicle. And those records will yield, for each vehicle, such data as the estimated operating life measured by vehicle miles, total maintenance costs applicable to each year or period of operating life, and the estimated scrap value at the end of its useful life. On the basis of such records, I shall now attempt to illustrate by example for a bus operation, the relationshp between maintenance and depreciation, and what I conceive to be a sound and more accurate method of reflecting those items.

The average cost of a new De Luxe bus, of the type used on an inter-city route amounts to $15,000. This represents the operating value of its component items; the body with its inside furnishings and equipment, and the chassis, including 100% functional efficiency of the engine and other units. During the first 50,000 miles of operation, no replacements or major motor adjustments are usually required; the maintenance cost for the operation of the bus in this period is practically nil. During the same period, however, the operating condition of bus, particularly its functional units, will show a decided deterioration; after 50,000 miles the first overhauling and replacement of parts will become necessary. Under current practice, the cost so incurred is charged in the subsequent period and not in the period wherein the 50,000 bus miles were made. Let us assume, for example, that the 50,000 bus miles were made in the first half year's operation of the bus. The cost for the use of the bus, attributed to the half year periods, on the basis of straight line depreciation, would be as follows:

	First Half Year	Second Half Year
Bus Miles Made	50,000	50,000
Depreciation Charge — (8 Year Life) Considering Scrap Value of $600	$ 900	$ 900
Maintenance Cost	None	1,500*
Total Cost for the Use of the Bus	$ 900	$2,400

* Computed at 3¢ per bus mile
Average cost per second 50,000 bus miles operated.

The discrepancy in cost between the first and second six month periods is quite apparent, and each subsequent year of operation will result in further variations of cost. To eliminate these variations, it is apparent that the depreciation and maintenance cost should be averaged over the useful operating life of the bus. In the example used, the depreciation charge applicable to the bus for the first 50,000 mile period should not only include the $900, but also a substantial proportion of the additional $1,500, which represents the cost of replacing the parts and adjusting the functional units to permit safe and efficient operation of the bus. It is correct to assume that the vehicle has depreciated to a greater extent during the first period than is reflected by the straight line method since the operating efficiency of the units shows the greatest decline in that first period and the decline decreases in extent for each subsequent period. The depreciation factors attributed to motor vehicles cannot, therefore, be compared with depreciation occuring in other capital items such as fixtures and buildings, which do not possess such intricate machinery and functional parts.

To develop and clarify further this proposal to coordinate maintenance costs and depreciation, I have prepared

EXHIBIT A

OPERATING TRAFFIC AND COST DATA

APPLICABLE TO GENERAL MOTORS CRUISER BUS — COST $15,000

Operation		Maintenance Cost*		Total Coordinating Cost Per Bus Mile	Total Coordinating	Depreciation Cost Ascertained As The Result Of Coordination Factors	
Year (a)	Bus Mileage Operated (b)	Cents Per Bus Mile (c)	Amount (d)	Depreciation And Maintenance (Cents) (e)	Cost Maintenance And Depreciation (f)	Amount (g)	Rate Per Bus Mile (Cents) (h)
1st	100,000	2½	$ 2,500.00	8¼	$ 8,250.00	$ 5,750.00	5¾
2nd	80,000	3½	2,800.00	8¼	6,600.00	3,800.00	4¾
3rd	65,000	5	3,250.00	8¼	5,362.50	2,112.50	3¼
4th	60,000	6	3,600.00	8¼	4,950.00	1,350.00	2¼
5th	50,000	7	3,500.00	8¼	4,125.00	625.00	1¼
6th	45,000	7½	3,375.00	8¼	3,712.50	337.50	¾
7th	40,000	8	3,200.00	8¼	3,300.00	100.00	¼
8th	30,000	8⅛	2,437.50	8¼	2,475.00	37.50	⅛
Total	470,000		$24,662.50		$38,775.00	$14,112.50	
Remaining Scrap Value.	30,000						
	500,000						

* Does not include cost of tires and tubes.

I.

COMPUTATION OF COORDINATING COST — MAINTENANCE AND DEPRECIATION — PER BUS MILE

Cost of Bus	$15,000.00
Less: Scrap Value Based upon 30,000 bus miles unused @ 3¢	900.00
Value of Bus to be Absorbed or Depreciated...	$14,100.00
Total Maintenance Cost of operation of 470,000 bus miles	$24,662.50
Total Cost representing Maintenance and Depreciation...	$38,762.50

Dividing the cost of $38,762.50 by the bus miles, 470,000, will result in the average coordinating cost per bus mile: 8¼ cents.

a factual analysis of a typical bus route based upon the costs and operating data of one of the major bus lines in this area. This data, reflected in the following table, analyzes the operation of a General Motors cruiser type bus during its complete operating life. The cost of the bus is $15,000, and the maintenance cost applicable to each mileage period has been ascertained from actual records of such costs applicable to this age period. The operating life of this bus is computed to be 500,000 bus miles.

Reference is now made to the accompanying Exhibit A entitled, "Operating Traffic and Cost Data."

Column (a) of this chart indicates the 8 years of operating life of the bus and Column (b) lists the corresponding bus mileage made during each of those years. The maintenance cost per bus mile, in cents, is noted in Column (c) and is based upon the average cost ascertained from my computation of actual maintenance costs (not including tires and tubes) covering the various periods in the life of the bus. The cost of tires and tubes has been omitted because they are usually rented at a stipulated rate per bus mile. The maintenance cost, as thus ascertained for each period in terms of cents per bus mile, is then multiplied by the number of bus miles operated during the period and results in the total maintenance cost for each period as noted in Column (d). The total coordinating cost per bus mile representing both depreciation and maintenance and indicated in Column (e) as 8¼ cents, is the result of the computations noted in Computation I. It represents the cost of the bus (after deducting its scrap value) plus the actual maintenance costs incurred during the actual life of the bus, divided by the number of miles actually operated. The total coordinating cost indicated in Column (f) and representing maintenance and depreciation is thus determined for each period by multiplying the bus miles operated in each period by the average coordinating cost of 8¼ cents per bus mile. The proposed depreciation rate per bus mile, reflecting the maintenance factor and noted in Column (h) is then computed by deducting from the average coordinating cost of 8¼ cents, the actual maintenance cost per bus mile noted in Column (c). The amount of depreciation applicable to each year, in dollars, is indicated in Column (g) and is ascertained by using the depreciating rate per bus mile noted in Column (h), or by deducting the maintenance cost noted in Column (d) from the total cost indicated in Column (f).

This table indicates a steady increase in maintenance cost per bus mile as the bus grows older, whereas the rate of depreciation per bus mile shows a corresponding decrease. It is submitted, therefore, that depreciation computed along the lines outlined in the table will not only reduce to a minimum the fluctuation in the yearly cost of operating the bus, but will also reflect more accurately the true operating cost for each year.

To illustrate the manner in which the proposed treatment of depreciation and maintenance may be recorded on the books of the Bus Company, let us consider the operation of a bus during its first year. Let us first assume that during the month of January, 1948, bus #100 covered 10,000 miles. The entry to give effect to the depreciation and maintenance of this bus would be as follows:

Depreciation of Bus #100	$575.00	
Maintenance Cost—Regular	250.00	
To Reserve for Depreciation on Bus #100		$575.00
To Maintenance Liability on Bus #100		250.00

To set up the above charges and respective credits for bus #100—covering operation of 10,000 bus miles of the first 100,000 mile base at the following determined rate:

Depreciation @ 5¾ cents per bus mile
Maintenance @ 2½ cents per bus mile

The following entry would then give effect to the operation of the same bus #100 for the next eleven months, assuming that it had made 95,000 miles in that period:

Depreciation Bus #100	$5,412.50	
Maintenance Cost—Regular	2,425.00	
To Reserve for Depreciation Bus #100		$5,412.50
Maintenance Liability on Bus #100		2,425.00

To record the above charges and respective credits for bus #100 covering operation of 95,000 bus miles—

Depreciation—

Of 1st 100,000 mile period—90,000 miles @ 5¾ cents	$5,175.00
Of 2nd 80,000 mile period— 5,000 miles @ 4¾ cents	237.50
	$5,412.50

Maintenance Cost—Regular

Of 1st 100,000 mile period—90,000 miles @ 2½ cents	$2,250.00
Of 2nd 80,000 mile period— 5,000 miles @ 3½ cents	175.00
	$2,425.00

Let us further assume that the records for the operation of bus #100 during this year indicate regular maintenance expenditures of $2,780.00 The ledger accounts covering the foregoing charges and credits would indicate the following:

Depreciation of Buses

January—Bus #100 (1 month)	$ 575.00		
December—Bus #100 (11 months)	5,412.00		
	$5,987.00		

Reserve For Depreciation of Bus #100

		January—1st 100,000 mile Period—10,000 miles	$ 575.00
		December—1st 100,000 mile Period—90,000 miles	5,175.00
		December—2nd 80,000 mile Period—5,000 miles	237.50
			$5,987.50

Maintenance Expense—Regular

January—Bus #100—For 1 month	$ 250.00		
December—Bus #100—Eleven months	2,425.00		
	$2,675.00		

Maintenance Liability or Deferment

Dec. 31—Expended for Regular Maintenance	$2,780.00	Jan. 31—Bus #100 (1 mo.)	$ 250.00
		Dec. 31—Bus #100 (11 mo.)	2,425.00
		Dec. 31—Balance	105.00
	$2,780.00		$2,780.00
Jan. 1—Balance	$ 105.00		

Maintenance items covering the usual replacement costs of parts, units and labor expended for the average wear and tear usage of the bus, is thus charged to the Maintenance Liability or Deferment Account. Repairs necessitated by accidents or major mishaps due to laxity on part of the driver or mechanic (such as driving the bus without oil or grease or with some apparent mechanical defect), should be charged directly to an account titled—"Maintenance Expense—Due to Accidents and Major Mechanical Failures" and not to the "Maintenance Liability Account." If the "Maintenance Liability or Deferment Account" for any one bus at the end of the year indicates a debit balance and is less than one year's credit provision, it should be treated as a Deferred Charge.

The amount in excess of the one year's credit provision should be adjusted by a corresponding charge to an account called "Maintenance Expense Adjustments — Coordinating Basis". Similarly, if the "Maintenance Liability and Deferrment Account", for any one bus, at the end of the year, indicates a credit balance in excess of one year's credit provision, this excess amount should be adjusted by a corresponding credit to the account titled "Maintenance and Expense Adjustments — Coordinating Basis".

The remaining balances in the "Maintenance Liability and Deferment Accounts" would represent, if a debit, additional expenditures applicable to the subsequent operating period; if a credit, expenditures necessary for the vehicle but not incurred, either because of laxity on the part of the Maintenance Department or inability to secure the required parts or units. Upon disposition of a bus all remaining balances in the "Maintenance Liability Account" would be closed out to the "Maintenance Expense Adjustments—Coordinating Basis." The same procedure indicated for bus #100 would be applied to any other bus or group of buses.

It is quite evident that the promulgation of a uniform charge for depreciation and maintenance, applicable to each operating year of a bus, will eliminate the apparent distortion of profits and costs during the operating life of a bus fleet, and will result in a true cost to be used in determining the net profit and the proper rates of fares to be charged.

The effect of the present variation in the computation of depreciation and maintenance costs in the bus industry may be illustrated by comparing the operation of two lines, Company A and Company B, over similar bus routes covering 1,000,000 bus miles in a one year period.

Company A operates a fleet of new General Motor Buses, with an original cost of $15,000 per unit; Company B operates a fleet of the same type of buses that have completed four years' operations. On the basis of the table previously described, Company A, having new buses, will require the use of only 10 buses to cover the 1,000,000 bus miles; and Company B, having buses that are on the fifth operating year, will require the use of 20 buses to cover the 1,000,000 bus miles. The accompanying summary of costs pertaining to each Company (Exhibit B) will consider both straight line depreciation of $1,750 per annum per bus (based on an eight year life and a $1,000 scrap value) and depreciation on the mileage basis at 3¢ per bus mile. The maintenance cost will be the same per bus mile as that indicated in the table.

EXHIBIT B

COMPARATIVE COST SUMMARY

	Company A		Company B		Variations Covering Present Basis Used — Company A As Compared With Company B Increase Or (Decrease)	
Number of Buses Used	10		20			
Total Cost of Buses Used	$150,000		$300,000			
Bus Miles Made	1,000,000		1,000,000			
Cost of Depreciation and Maintenance	**Straight Line Basis**	**Mileage Basis**	**Straight Line Basis**	**Mileage Basis**	**Straight Line**	**Mileage Basis**
Depreciation	$17,500	$30,000	$ 35,000	$ 30,000	($17,500)	$ -0-
Maintenance Cost at 2½ Cents per bus mile on 1st 100,000 miles per bus in 1st year—7 cents per bus mile for 5th year operation	25,000	25,000	70,000	70,000	(45,000)	(45,000)
Total Cost	$42,500	$55,000	$105,000	$100,000	($62,500)	($45,000)
Total Cost based upon Proposed Average Coordinating Cost at 8¼ cents per Bus Mile	82,500	82,500	82,500	82,500		
Differences:						
Understatement of Cost, represents increase in depreciation	$40,000	$27,500				
Overstatement of cost, represents decrease in depreciation			$ 22,500	$ 17,500		

The accompaning summary indicates that Company A's net profit, when compared with the result obtained under the proposed "Coordinating Cost" method, would be higher by $40,000 if the straight line method were used and by $27,500 if the mileage basis were used. By the same token, Company B would show a decrease in profit or excess loss of $17,500 if the mileage basis were used and $22,500 under the straight line method. Similar results of varying degree will apply to buses having life periods different from those used for Company A and B.

If the discrepancy in the cost computation for Company A had occurred during the high excess profit tax years, the penalty for the understatement of its cost or the overstatement of its profit would have amounted to approximately 85% of $40,000 or $25,500. It could also have resulted in an order by one of the utility commissions requiring a reduction in fares.

Similarly, the overstatement of the costs noted for Company B would result in a false picture of its net operating condition and could force a curtailment of personnel and schedule trips, resulting in a further and truly adverse effect on its net profits. In both instances, of course, the disadvantages are in addition to those usually inherent in a misstatement of income.

On April 30, 1948, the National Association of Motor Bus Operators released a survey covering the operation of Inter-City bus companies for the period 1939 through 1946. This survey indicates an increase in maintenance cost of approximately 300%, of which 100% may be due to higher prices of parts and higher wages paid to mechanics and helpers. The remaining 200% is attributable to the fact that the average age of the buses used in 1946 was at least two or three times greater than the average age in 1939. In 1939, new buses were readily obtainable and many executives, aware of the fact that it was uneconomical to run buses after a 5 year operating life, were constantly replacing their old equipment. But adequate replacement was impossible in 1946 and the average age of the buses in use in 1947 therefore rose to 7 years.

If the proposed method of coordinating maintenance and depreciation had been in use during the period 1940 to 1945, the excess profit tax years, the bus companies would have reflected their true maintenance and depreciation costs. As indicated by the comparative analysis of Company A and B operations, these costs would undoubtedly have been higher than the costs actually reported and would have resulted in a corresponding decrease in taxable net income and a consequent reduction in Excess Profit taxes paid. The additional earnings reported in those years therefore represented additional depreciation charges not taken, though applicable to that period. The allocation of the proper depreciation charges to the period prior to 1945 would also have resulted in lower depreciation charges for 1946 and 1947, and would have reflected a truer and more normal picture of the operations for those years. And the cash expended for taxes erroneously paid in the prior periods could have been retained by the companies to bolster the unfavorable cash position in which many bus companies find themselves today.

In conclusion, and because most of my remarks have concerned passenger carriers, I should perhaps dispel any notion that they are intended to apply only to such companies. The property carriers operating trucks, trailers and tractors are affected in the same way, and to the same extent.

Accounting for Gain or Loss on Trade-In of Equipment Under the I.C.C. Uniform Accounting System

By LEON KONSEVICK, C.P.A.

DURING the war period, most companies were not concerned with the problems arising out of trade-ins. Old equipment was simply junked or used for valuable spare parts. With the return to normal times, however, any company subject to the supervision of the Interstate Commerce Commission, Bureau of Motor Carriers, again has the problem of accounting for the gain or loss on the trade-in of equipment, and the subsequent basis to be used for depreciation.

As for recording cost under the I.C.C. Uniform System of Accounts for Class I Motor Carriers, the prescribed accounting regulations provide that equipment shall be recorded at actual cost and not adjusted by the undepreciated balance of equipment traded in, as prescribed by the Federal Income Tax Regulations. Actual cost is defined as the usual accounting conception of cost, including delivery expenses, installation charges, and expenses in connection with the acquisition of equipment. Interest and finance charges on installment notes are not included in cost but are amortized over the life of the notes.

When a unit of carrier operating property depreciated under the unit plan is disposed of at an amount in excess of its net book cost, under I.C.C. regulations such amount should be credited to account 2933—Other Credits to Surplus (assuming that the carrier is a corporation). The I.C.C. also prescribes an account, 5091—Depreciation Adjustment, to be used as a guide to management with respect to experience with depreciation rates. When the excess amount received on the sale of equipment is due in part to an over-accrual of depreciation as the result of an incorrect estimate of its service life, the portion representing the over-accrual should be credited to Depreciation Adjustment account 5091. If credit entries are made consistently whenever equipment is sold, dismantled, or otherwise disposed of, the depreciation rates have been too high. The reverse would be true if retirements continually resulted in debit adjustments to Depreciation Adjustment account 5091.[1] Under present income tax regulations, on the other hand, no gain or loss is recognized as a result of trading-in equipment used for business purposes for new equipment. This regulation is the result of the Commissioner's acquiescence in the *Hartman* decision by the Tax Court.

The position of the I.C.C. is supported by common accounting practice as well as the regulations of those states which were investigated: New York, New Jersey, Pennsylvania, and Connecticut. The "Accountants' Handbook, 1943 Edition," pp. 680-681, states that common treatment is to charge the new equipment in at its stated selling price. The profit (or loss) realized is considered to be the difference between the net book value of the asset and the

LEON KONSEVICK, C.P.A., received his experience in the transportation field through his four year association with N. L. Fish & Co. He has been a member of the New York State Society since 1942 and is presently serving on the Committee on Land Transport Accounting.

[1] Letter dated May 14, 1946, from W. Y. Blanning, Director, Interstate Commerce Commission, Bureau of Motor Carriers.

trade-in allowance received. The Handbook points out, however, that a more sound and conservative treatment is to substitute for the nominal allowance, the amount of cash which the old unit would bring if sold outright to a local second hand dealer (the market price). Professor H. A. Finney in his "Principles of Accounting, Intermediate," pp. 253-254, states that the method of recording the transaction depends on the available information. If the information is available, the new asset should be put on the books at the ascertainable market cost value and the resultant gain or loss computed on that basis. If, however, the new asset has no ascertainable market value, then he states that no profit or loss on the exchange can be determined and the new asset should be put on the books at the book value of the old asset plus the amount of the cash payment. This is the same as the income tax basis.

I wrote to the Director of the Bureau of Motor Carriers for an explanation of the position taken by the I.C.C. I was informed,

> "It is our opinion that the Bureau of Internal Revenue Regulations with respect to accounting for losses and gains on trade-ins results in distorting cost figures. Obviously, the cost of one vehicle has no relationship to the cost of one purchased subsequently. For instance, if four vehicles had been traded in for replacements over a period of time, each costing $2,000 and each retirement resulting in a $500 credit adjustment, the first replacement under Bureau of Internal Revenue rules would be recorded at a cost of $1,500, the second at $1,000, the third at $500 and the fourth at no value, with the result that the balance sheet would be misstated by the amount of $2,000. It appears that the Bureau of Internal Revenue regulations are merely an expedient for tax return purposes in that they preclude the reopening of prior year's returns for reassessment or refund."[2]

The following example illustrates the various methods of accounting for the gain or loss on trade-ins. Assume the following situation:

Cost of asset	$2,000	
Reserve for depreciation	1,000	
Book value		$1,000
Purchase price of new asset	$2,500	
Trade-in allowance	1,250	
Cash paid		$1,250
Market price of old asset		$ 900

Computation of profit:	I.C.C. Basis	Income Tax Basis	Market Price Basis
Trade-in allowance	$1,250	—	—
Market price of old asset	—	—	$ 900
Book value	1,000	—	1,000
Profit or loss	$ 250	none	$ (100) (loss)
Basis for subsequent depreciation or sale:			
Purchase price	$2,500	$2,500	$2,500
Excess of trade-in allowance over depreciated cost or market price	—	250	350
Adjusted basis	$2,500	$2,250	$2,150
or:			
Cash paid	—	$1,250	$1,250
Book value of old asset	—	1,000	—
Market value of old asset	—	—	900
Adjusted basis	$2,500	$2,250	$2,150

[2] *Ibid.*

I believe that the market price basis is superior to both the I.C.C. basis and the income tax basis. The Director of the I.C.C. Bureau of Motor Carriers stated that the cost of one vehicle has no relationship to the cost of one purchased subsequently, but very often the trade-in value allowed by the seller bears little resemblance to the true market value of the old asset, but is used as means of allowing a hidden discount or adding an additional premium to the purchase price of the new asset. Market value must be considered, therefore, if we wish to arrive at undistorted cost figures.

Under present conditions, however, most companies do not choose the method which is theoretically correct, but rather the one which is the most practical. Those companies not subject to the I.C.C. uniform accounting system usually account for the gain or loss on the trade-in of equipment in the manner prescribed by the income tax regulations, in order to avoid tax adjustments year after year for amounts which are usually not material. Those carriers subject to the I.C.C. regulations, however, must keep their accounting records in conformity with the Uniform System of Accounts and also maintain some sort of record of the income tax basis. Some carriers keep both I.C.C. and income tax basis in their general ledgers. Another method would be to record the I.C.C. basis in the general ledger but to maintain the income tax basis in subsidiary property records or in the accountant's working papers. And yet, if the carrier wished to record the true cost of its equipment, it would have to keep three sets of property records. 1) I.C.C., 2) Income Tax, 3) Market Value.

I know that this problem is not a momentous one compared with others facing practicing accountants today. But if all interested parties could agree on one best method then, at least, one problem facing the transportation accountant would be solved.

SYMBOL OF SERVICE

When is Interest Income Taxed and When is it Tax Free?

By Leslie Mills, C.P.A.

I—Introduction

There is no room for argument about the inclusion of interest in income. Any economist or accountant would assure us that the inclusion in the definition of taxable income of the phrase "gains or profits and income derived from any source whatever" would encompass interest. Presumably just to be sure, every income tax statute passed by the Congress since the Sixteenth Amendment, and in fact those prior income tax acts of the Civil War period, have specifically provided for inclusion of interest in income subject to tax.

Under what circumstances, then, is interest income not taxable? *First,* when the Congress provides specifically that it is not to be taxed (or the Courts tell the Congress that it does not have the power to tax it). *Second,* when the item called "interest" is in fact something else. While a rose by any other name will smell as sweet, if it is not a rose the name won't make it one. *Third,* when the interest, admittedly income, is not properly assignable to the period for which income is being determined. Since our system of income taxation is based on annual periods separately considered, and accounting methods prescribed or elected, the time as well as the nature of any item must be considered.

Leslie Mills, C.P.A., has been a member of the Society since 1934 and is a member of the Federal Taxation Committees of the Society and of the American Institute of Accountants. He is a partner of a prominent New York firm of certified public accountants.

This paper, from a lecture before the New York University Sixth Annual Institute on Federal Taxation (November, 1947), is reprinted by permission of New York University and Matthew Bender & Company, publishers of the *Proceedings* of the Institute.

II—Exclusion of Interest from Taxable Income by Specific Statutory Provision

While there still might be argument as to the constitutional power of the Congress to tax interest on obligations of a State[1], the problem is not currently important since the Code[2] specifically provides for exclusion from taxable income of interest upon the obligations of a State, Territory, or any political subdivision thereof, or the District of Columbia. However, difficulty can arise, and litigation has ensued, on two questions: (1) what is a political subdivision of a State, and (2) how all embracing is the term "obligation".

Cities, towns, counties, etc., are clearly political subdivisions of the State. Special assessment districts such as road, water or sewer districts may or may not be included in the term. The Treasury has ruled[3] that this question is to be determined by whether or not the State has delegated to the district the right to exercise part of its sovereign power — for example, the power to tax. The Treasury made a strong effort[4] to tax interest on bonds of the Port of New York Authority and the Triborough Bridge Authority on the grounds that these bodies were not instrumentalities of a State within

[1] See discussion in *Com.* v. *Shamberg,* 144 F. (2) 998, aff'g. 3 T.C. 131; cert. den., 323 U. S. 792.

[2] Sec. 22 (b) (4) I.R.C.

[3] Reg. 111, Sec. 29.22 (b) (4)-(1).

[4] *Com.* v. *Shamberg,* citation #2. *Com.* v. *White,* 144 F. (2) 1019, aff'g. 3 T.C. 156; cert. den., 323 U. S. 792.

the meaning of the exempting clause. However, despite a Supreme Court decision[5] holding that the Port of New York Authority was not performing an essential government service, it was held that it was a political subdivision of the State, bringing interest on its obligations under the exempting provisions of the Code.

The matter of what is covered by the term "obligation" has also been productive of litigation. It has been held that it includes not only bonds, but also an obligation created in exercise of a State's borrowing power and evidenced by an ordinary written agreement of purchase and sale[6]; but it does not include an open account incurred by a township without exercise of its borrowing power.[7] There is conflict as to the exemption of interest on bonds issued by cities, etc., payable only out of special assessment on properties on which the proceeds of the loan were used. The regulations provide[8] that special tax bills collectible only from owners of the property benefited are not obligations of a State or political subdivision. However it seems that if the city is directly liable on the bonds, the interest is exempt[9], no matter what special provision is made for liquidating the debt.

It seems clear that the objective of the statutory exemption is to remove a burden from the taxing powers of the local governments; or, to state it in reverse, to enhance their borrowing power by enabling them to grant tax exemption to their creditors, who will then be satisfied with a lower interest return. On this basis, the rulings and decisions discussed above fall into a pattern: if the borrowing power of the local government is involved, the exemption should apply no matter what form it takes; while a debt originating in a transaction such as purchase of supplies does not involve borrowing power, and therefore is without the exemption provision, as also would be a security such as a tax-sale certificate which represents not so much an original borrowing but rather an immediate realization of delinquent taxes assessed.[10]

The same philosophy indicates the answer to the problem of State or local government securities issued at a discount. Since the difference between the issue price and maturity value is all or part of the interest element, it represents tax free income.[11] If the securities were sold before maturity, or between interest dates, an apportionment must be made to separate the exempt interest element.[12] No more than the excess of face amount over issue price of a non-interest-bearing security can be exempted, so that if such a security is redeemed at a premium, the premium is a taxable gain.[13] If interest bearing State securities are sold between interest dates, it is important to specify the amount of the price which represents accrued interest, so that the seller may secure the full benefit of exemption of the interest. Profit on sales of securities of State or local governments is fully taxable.[14]

An interesting sidelight on the philosophy of the power of our various governments to tax interest paid by another government unit arose last month in the Pennsylvania Courts.[15] Here the State Court held that under the Pennsylvania corporate income tax, interest

[5] *Helvering* v. *Gerhardt*, 304 U. S. 405.
[6] *Kings County Development Co.*, 93 F. (2) 33; cert. den., 304 U. S. 559.
[7] *Kurtz Bros.*, 42 B.T.A. 561.
[8] Reg. 111, Sec. 29.22 (b) (4)-(1); but see *Bryant* v. *Com.*, 111 F. (2) 9.
[9] *Com.* v. *Pontarelli*, 97 F. (2) 793, aff'g. 35 B.T.A. 872.
[10] *Wiltsie* v. *U. S.*, 3 Fed. Supp. 743; cert. den., 291 U. S. 664.
[11] G. C. M. 10452, I.T. 2629.
[12] I.T. 1187.
[13] G. C. M. 21890.
[14] *Willcutts* v. *Bunn*, 282 U. S. 216.
[15] *Penna.* v. *Curtis Publishing Co.*, Court of Common Pleas, Dauphin Co., Penn., 10/10/47.

on U. S. securities issued after March 1, 1941, cannot be included in taxable income. Since the State tax law provides for exclusion of interest on State and municipal securities, the court held that inclusion of interest on U. S. securities (even although such interest is subject to federal income tax) was discriminatory and therefore unconstitutional.

The tax status of interest on obligations of the United States and its instrumentalities was completely revised by the Public Debt Act of 1941, which provided basically that interest on such debts issued on or after March 1, 1941, is fully subject to all federal income and excess profits taxes. Thus, the question of taxability of such interest requires determination of the date of issue of the security and of the provisions with respect to taxation included in the statute which authorized the borrowing. It is important to note that there may be provision for complete exemption from all taxes on income, or partial exemption from one or more specified taxes. The instructions provided with the tax returns ordinarily provide a sufficient guide to the tax status of the various federal securities.

The change made as of March 1, 1941, requires allocation of interest received on postal savings deposits since interest on such deposits made prior to that date is fully tax exempt while that on deposits made after February 28, 1941, is fully taxable. The exemption on prior deposits applies even if a new certificate covering all deposits is issued.[16]

Discount on savings bonds (series E available to individuals only, and series F for all taxpayers) represents taxable interest. While cash basis taxpayers may defer reporting the increment in value until it is realized by redemption or maturity, they may elect to accrue the increment in value as income in accordance with the redemption values shown on the bond.[17] Accrual basis taxpayers must report income currently on the basis of the redemption tables.[17] While Series E bonds may be registered in the name of two persons, the income is taxable to the one who provided the purchase price. Upon the death of a taxpayer, increment to the date of death, not previously reported, must be returned as taxable income. Since Series E bonds cannot be transferred by sale, no problem should arise as to gain or loss on sale.

Series G bonds, which are interest bearing, present a problem since for a time after their issue the redemption value is less than the issue price. On the theory that the loss on such advance redemption represents a recovery by the Treasury of interest previously paid, it has been held that such "loss" is fully deductible in the year of the redemption.[18]

Section 42(c) of the Internal Revenue Code provides a special rule that discount on short term non-interest-bearing government obligations does not accrue until the obligations mature or are disposed of, regardless of the tax accounting basis employed by the taxpayer. Section 117(a) excludes such obligations from the definition of capital assets.

The problems of amortization of bond premiums and discount are reviewed in the last section of this paper. Since amortization of premium is in effect an offset against interest to be collected, special rules are required for securities the interest on which is wholly or partly exempt from income tax. No deduction is allowed for amortization of premium on wholly tax-exempt bonds[19] but the amortization must nevertheless be subtracted from the basis for determining gain or loss on sale, exchange or redemption of the security. The effect is thus to

16 I.T. 3562.
17 Mim. 5299, and I.R.C., sec. 42.
18 I.T. 3504.
19 Sec. 125 (a) (2), I.R.C.

require amortization of the premium and, by disallowing deduction of the amortization, to exclude from taxable income only the effective rate of the interest.

Deduction is allowed for amortization of premium on a partially exempt bond,[20] but the effect of the deduction is offset insofar as concerns the portion of the tax to which the exemption applies. This is accomplished by reducing the credit for partially tax exempt interest by the amount of the amortization allowed as a deduction. For example, net income subject to surtax includes partially exempt interest and a credit is allowed for such interest in the computation of normal tax interest. If premium on such bonds is being amortized, the amortization deduction is subtracted from the credit, with the result that only the net amount of the interest is excluded from normal tax net income. Since certain U. S. Treasury bonds are wholly tax exempt up to $5,000 principal amount and partially tax exempt thereafter, purchase of such bonds at a premium will require separation into wholly exempt and partially exempt portions, with separate treatment of each portion.[21]

All taxpayers must amortize premiums on wholly exempt bonds, and corporations must also amortize premiums on partially tax exempt bonds; individuals have an option in the case of the latter. An exception is provided for dealers in securities[22] who may not amortize premiums on securities which constitute stock in trade. This may be of material tax advantage as it can result in receipt of interest fully tax exempt coupled with a loss on sale of the bonds, fully deductible since the loss would not be a capital loss. However, it has been held[23] that a taxpayer can be both a dealer and a trader at the same time, so that holding of a tax exempt security for such a considerable time that the market value was affected by amortization of the premium might result in classification of the transaction as an investment, in which case the loss would be disallowed.

An important point for individual taxpayers to remember is that the standard deduction provided for by section 23(aa) of the Code includes deduction for premium amortization, so that if use of this standard deduction is likely, election to amortize premium on partially exempt bonds will increase the tax payable.

The exempt status of interest on government obligations is a valuable right, and it is properly available only to the true owner of the obligation and the interest thereon. Scrutiny can be expected of arrangements made to give the benefit of the exmption to another, by means of spurious or ineffectual transactions. The Treasury has ruled that agreement for purchase and resale of tax exempt securities between a bank and its customers will not be effective in giving tax exemption to the portion of the bank's interest income collected from the securities.[24] The limited disallowance of deduction for interest paid on indebtedness incurred to purchase wholly tax exempt securities is another indication of the intent to prevent tax avoidance by means of tax exempt interest.[25]

III—Exclusion of Interest from Taxable Income Because it is not Truly Income

Cash basis taxpayers must report interest income only when received, although even such taxpayers may, under the constructive receipt rules discussed later in this paper, be required to report interest as income in advance of the ac-

20 Sec. 125 (a) (3), I.R.C.
21 I.T. 3699.
22 Sec. 125 (d), I.R.C.
23 *Vaughan* v. *Com.*, 85 F. (2d) 497; cert. den., 299 U. S. 606.
24 G.C.M. 12355; see, also, *First Nat'l Bank Wichita,* 19 B.T.A. 744.
25 G.C.M. 8868.

tual receipt of cash. The general rule for accrual basis taxpayers is that interest must be reported as it accrues. But acceptable accounting principles recognize that even on the accrual basis income does not result if there is reasonable doubt that it will ultimately be collected, and fortunately there is ample support for maintaining this position for tax purposes. However, as with all exceptions to a general rule, the burden is placed upon the taxpayer to demonstrate clearly that factors existing and known during the taxable year made collection of the interest unlikely. It is not enough to show that the interest was in fact never collected.[26]

It still seems to be the official position of the Treasury Department that interest must be reported as accrued even although it is known during the taxable year that no collection will be made at any time.[27] In this ruling a taxpayer put the question flatly as follows:

> "Is interest on accounts, the principal of which is only partially realizable, and the interest if charged up and added to such principal not realizable at all, income or not?"

The Treasury's answer was that the interest must be accrued, and that the taxpayer was entitled to claim deduction for such accounts as could be ascertained to be uncollectible. This of course put a burden on the taxpayer which, particularly under prior revenue acts, could be quite onerous. However, in actual practice, exclusion from income of interest, collection of which is doubtful, has been given ample support by the Courts, frequently with acquiescence by the Treasury. Therefore let us examine some of the cases to find a pattern for application of the rule.

Probably the most unequivocal statement of the rule was made by the Second Circuit[28] in which the Court said:

> "A taxpayer should not be required to pay a tax when it is reasonably certain that such alleged accrued income will not be received and when, in point of fact, it never was received. A taxpayer, even though keeping his books upon an accrual basis, should not be required to pay a tax on an accrued income unless it is good and collectible, and where it is of doubtful collectibility, or it is reasonably certain it will not be collected, it would be an injustice to the taxpayer to insist upon taxation.
>
> "A taxpayer cannot be charged to have realized an income unless there exists reason for believing that the income is likely to be paid or can be collected."

Subsequent to the above case, the Board of Tax Appeals held[29] that no accrual should be made of accrued but unpaid interest on notes of a company, 50% owned by the taxpayer, when the liabilities of the debtor exceeded the value of its assets and when it sustained deficits during the taxable years in question. The same philosophy was followed in the recent TaxCourt case of *Cuba Railroad Co.*,[30] in which it was held that service income due and payable should not be accrued when the debtor, while acknowledging the claims, refused to pay them and the taxpayer had no means of enforcing them. An extension of the rule was also made by the Tax Court[31] when it held that no income accrued under an agreement by which the interest was expected to be paid in due course but no payment reasonably could be expected for some twelve or fifteen years in the future. The fact that the payer was allowed current deductions for the interest was held to be not significant.

Decisions denying exclusion of interest from taxable income emphasize the need for demonstration of doubt of collectibility on the basis of factors exist-

---

[26] *O'Sullivan Rubber Co., Inc.*, 42 B.T.A. 721.
[27] A. R. M. 737, I-1 C.B. 52.
[28] *Corn Exchange Bank*, 37 Fed. (2d) 39.
[29] *Atlantic Coast Line*, 31 B.T.A. 730.
[30] *Cuba Railroad Co.*, 9 T.C., no. 34.
[31] *Scheuer*, B.T.A. memo., Docket 09014, 1943.

ing during the taxable year.[32] In one case[33] the taxpayer loaned money to a debtor who used the funds to pay interest on bonds, some of which were owned by the taxpayer. Although the advances were made with the reasonable knowledge that they would *not* be repaid, nevertheless accrual of the interest as income was required. It could not be excluded when in fact it was later received in cash. Incidentally the worthless advances were held not deductible on two grounds, (a) they were in the nature of contributions to capital, and (b) they were not timely charged off on the books. The same principle was applied by the Board of Tax Appeals[34] which held interest accruable on debts because it was paid despite the fact that payment was made possible only by additional advances by the creditor. In another case[33] claim for exclusion was made on the grounds that the debtor was in receivership. The claim was denied since the taxpayer was held to have had at the end of the taxable year "reasonable expectation" of collection. The debtor went into receivership *after* accrual of the interest, and the court distinguished the prior case just mentioned,[28] in which the debtor was in receivership *at the end* of the taxable year of accrual of the interest.

To summarize, therefore, interest need not be accrued if, at the end of the taxable year of accrual, there is no reasonable expectation of collection, but if in fact it is subsequently collected, or if its uncollectibility is based on factors or knowledge arising *after* the year of accrual, it must be reported as income and deduction of the taxpayer's loss will have to be sought under the deduction sections of the law.

The same theory applies to receipt of a note for interest due or accrued. In effect this may be a taxable exchange, and income may be realized measured by the fair market value of the property received.[35] If the property received has no fair market value, no gain or loss can be recognized.[36] If property received on account of accrued interest had a fair market value in excess of the accrual of interest, the excess would be taxable gain; if it had no ascertainable value, the property received would have as a basis the amount of the accrued interest; in both cases the interest would be deemed to have accrued. But if the property received were worthless, that fact would be support for contention that the interest was uncollectible and should not be accrued.[38] But it has been held that receipt of new notes representing principal and accrued interest on existing obligations did not result in taxable income to a cash basis taxpayer since it was not in effect payment of the interest.

Probably the most important basis for excluding from income receipts designated as "interest" is demonstration that all or a portion of the receipt represents a return of capital, or is in fact not actually income. The accounting concept of correcting interest income to recognize premium or discount reflected in the purchase price of the security has long been accepted. Recognition of this sound accounting practice was accorded by the Revenue Act of 1942,[39] which provided for amortization of bond premiums, and incidentally plugged a leak in the revenue system whereby taxpayers were allowed deduction of a capital loss on maturity or other disposal of tax exempt bonds although the premium creating the loss had been recovered in the form of tax exempt interest.

---

32 *American Cigar Company*, 66 F. (2d) 425.
28 *Corn Exchange Bank*, 37 Fed. (2d) 39.
33 *Broderick* v. *Anderson*, D.C., 23 Fed. Supp. 488.
34 *Langley*, 35 B.T.A. 1297.
35 Sec. 111, I.R.C.
36 *Gould Securities*, 96 F. (2d) 780.
37 *Mellinger*, 21 Fed. Supp. 964.
38 *American Central Utilities*, 36 B.T.A. 688 (A).
39 Sec. 125, I.R.C.

The rules for amortization of premium on bonds, interest on which is wholly or partially tax exempt, have already been discussed. With respect to fully taxable bonds, all taxpayers are given an election to amortize bond premiums and to deduct the amortization currently, the amortization becoming an adjustment of the basis for the security.[39] [40] Once the amortization election is made, it is binding for future years unless the Commissioner grants permission to change. Since the election was granted by the 1942 Revenue Act, unamortized premium for years beginning before 1942 continues to be part of the basis of the security. Finally, the amortization election is not available to dealers in securities with respect to bonds held in their inventory, since such securities are excluded from the statutory definition of bond.[41]

The Regulations permit use of the method of amortization employed by a taxpayer prior to 1942[42] if the method be reasonable, and prescribe the straight-line method otherwise. They also recognize that bond premiums may consist wholly or partly of expenses of acquisition, and provide the flexible rule that even if the taxpayer is required to amortize premiums, with respect to bonds the premium on which consists entirely of acquisition expenses it may amortize these expenses or not, according to its regularly employed accounting practice.

Special rules are provided for callable and convertible bonds, holders of which may amortize to the earliest "call" date. If on that date the bond is not redeemed, the holder may continue amortization to the next date. If the option to convert a bond rests with the bond holder, the premium may be amortized.[44] The Treasury has taken the position that amortization is not permissible with respect to a premium due at maturity or a "call" date if the premium represents the market value of the conversion option rather than a true investment premium. While this ruling prevents manipulation for tax avoidance, it seems to have no sound basis in the law.[45]

If taxpayers acquire securities for less than maturity value, good accounting requires that the discount, which represents interest, be accrued ratably over the period to maturity. This sound accounting procedure has long been recognized for tax purposes.[46] Use of the proper accounting for discount by accrual basis taxpayer has been required by the courts even when in error the same amounts have previously been reported as taxable income.[47] Cash basis taxpayers, however, report discount as income only when it is collected. Thus a cash basis taxpayer may be able to convert the discount element of interest into capital gain by selling the security before maturity. To the extent that recovery of the discount is reflected in the selling price it will thus be represented by gain on the sale.

Since the cash basis rule may work hardship, particularly as to non-interest bearing discount bonds, by bunching discount in one taxable year, a special rule has been provided, as noted above, for U. S. Treasury Savings bonds, permitting such taxpayers to adopt the accrual basis for such securities as an exception to the accounting basis used for other income items.

It may be noted in passing that as to an issuer on the accrual basis, bond discount and premium must be accounted for as income or expense ratably over the life of the bonds.[48]

---

40 Sec. 113 (b) (1) (H).

41 Sec. 125 (d), I.R.C.

42 Reg. 111, Sec. 29. 125-3.

44 Reg. 111, Sec. 29. 125-5; G.C.M. 24078.

45 Special ruling, 2/17/45, on American Telephone & Telegraph Company 3% convertible debentures of 9/1/56. See discussion, page 44 of Investor's Tax Planning, by John P. Allison.

46 *Chatham & Phoenix*, 1 B.T.A. 460 (A).

47 *Chemung Canal Trust Co.*, 30 B.T.A. 230; aff'd. C.C.A.-2.

48 Reg. 111, Sec. 29.22 (a) (17) (2) (a) and (3) (a).

A prime example of receipts labeled interest, constituting in fact a return of capital, arises from investments in bonds with interest in arrears. If such securities are purchased "flat", the purchase price is divisible into a portion for the principal amount, and a portion for the defaulted interest. Collection of the defaulted interest is not income, but is a return of capital which reduces the basis of the security.[49] Not until aggregate collections of such interest exceed the entire basis will the bondholder receive taxable income. Of course, if the interest itself were tax free (a municipal bond, for example) the result would be to convert tax free income to taxable capital gain.[50]

While receipt of interest arrears which accumulated while a security was owned by a taxpayer will constitute ordinary income, fully taxable, it frequently is possible to convert it into capital gain taxable at only 25% by selling the bond before the interest arrears are paid. Presumably the imminent payment of the interest will be reflected in the sales price. In any event, the bonds can be repurchased after the sale with the result that the interest receipts will represent a return of capital. If the sale is at a profit the wash sales provisions will not apply.

The importance taxwise to both purchaser and seller of property of whether any part of an agreed sales price represents interest is obvious. To the extent that an interest element does exist, the seller will receive ordinary income fully taxable instead of perhaps capital gain, while the buyer will have an interest deduction instead of an increase in basis for the property purchased. While the desires of the parties taxwise may conflict, the most advantageous position may be arranged in many cases. For example if a taxpayer sells property with the proceeds payable in installments and provides for interest on the unpaid portions of the purchase price, receipts of the interest will constitute ordinary income. If by adjusting the sales price he made the installments non-interest bearing, they would all represent proceeds of sale of the property. But the interest element must be clearly designated. In one case[51] a taxpayer claimed that the excess of the price of an article sold on the deferred payment plan over the cash price of a similar article represented interest charged in advance and not taxable until due. The Court did not agree. However in another case[52] a contract for sale of realty specified a "purchase price including interest" and the Court held that a portion of the periodic payments represented deductible interest to the purchaser and not a part of the basis for the property.

The problem of classification as interest of a portion of a sales price has been given particular consideration in the two special situations of mortgage foreclosures and condemnation awards, sometimes with startling results. The Supreme Court has held[53] that if a taxpayer forecloses on mortgage loans and at the foreclosure sale acquires the mortgaged property by bidding the full amount of the mortgage plus accrued interest, it has realized taxable interest income. This rule applies even if the true value of the property is less than the bid price. Thus *taxable income* can be realized on a transaction which results in an *economic loss*. Obviously, unless it is desired to accrue taxable income in the year of the foreclosure sale, a mortgagee should bid no more than the principal amount of the mortgage loan. However, lower courts have held that in the case of a voluntary conveyance of property in satisfaction of mortgage debt, if a value for the property is shown, income accrues only to the

49 *Hewitt*, 30 B.T.A. 962.

50 *Pierce*, 120 F. (2d) 206.

51 *Anderson*, 6 B.T.A. 713.

52 *Hudson Duncan*, 36 B.T.A. 554; see, also, *Mac Laughlin v. Harr*, C.C.A. (3), 99 Fed. (2d) 638, for an example of interest representing recovery of capital.

53 *Midland Mutual Life Insurance Co.*, 300 U. S. 216.

extent of the excess of such value over the principal of the mortgage.[54]

Subsequent to the Supreme Court decision noted above, the Sixth Circuit held that the senior court decision applied only to insurance companies and that no interest income was received if the value of the property received was less than the mortgage debt.[55] Only the Supreme Court can give the last word on this matter.

It is interesting to note that one of the recommendations of the McGill Special Tax Study Committee calls for exemption from tax of the interest element in a mortgagee's foreclosure bid.

Two basic problems arise when interest is received on an award for condemnation of property—(1) is the interest taxable as ordinary income, or is it part of the purchase price, and (2) if it is interest, is it tax free if paid by a state or political subdivision of a state? The Supreme Court has answered both questions against the taxpayer, holding that the interest portion of a condemnation award is ordinary taxable income since it represents an addition to the sales price for the period from the date the property was taken[56] and that it is not tax exempt interest.[57] The interest represents taxable income even though the taxpayer suffered a loss on the condemnation.[58]

The Board of Tax Appeals made an interesting application of these rules in a 1938 case[59] in which it held that interest received by an estate on a condemnation award was interest income to the estate but when distributed to an heir was free of tax as a devise of proceeds of property.

It is obvious that a portion of every life insurance payment made on maturity of the policy contains an element of interest. It has long been the law[60] that insurance proceeds paid as the result of death are tax exempt. But it took a series of adverse court decisions to settle the tax status of the interest element of installments paid by agreement with the insurer. It is now settled by regulation[61] that the entire proceeds of a policy maturing as the result of death are tax free, even if the proceeds are paid in installments in accordance with an option exercised by the insured or by the beneficiary.

However, if the proceeds are held by the insurer for investment, the interest paid is taxable income, and this rule applies even though the periodic interest payments are provided for by the policy, so long as they do not include payments of principal.[62]

The law provides for exception to the above rule if the policy was acquired for a valuable consideration[63] in which case maturity may create taxable income, and it should also be noted that the tax free provision applies only to proceeds paid as a result of death of the insured. If a policy is surrendered, the excess of cash value over net premiums paid is gain, taxable as ordinary income.[64] This provision, in effect, allows receipt without tax of part of the interest element in insurance. Part of every insurance premium is for pure insurance risk and part is for investment, but nevertheless recovery of the entire premium cost is allowed before taxable gain is realized. On such transactions, the gain may be transferred from ordinary income, fully taxable, to capital gain, taxable at a lower rate, by assigning the policy for consideration.

---

54 *Missouri State Life Insurance Co.*, C.C.A. (8), 78 Fed. (2d) 778.
55 *Nichols*, 141 F. (2d) 870.
56 *Kieselbach*, 317 U. S. 319.
57 *U. S. Trust Co.* v. *Anderson*, 65 F. (2d) 575; cert. den., 290 U. S. 683.
58 *Johnson & Co.*, 55 Fed. Supp. 764.
59 *Jamieson Associates, Inc.*, 37 B.T.A. 92.
60 Sec. 22 (bX1), I.R.C.
61 T. D. 5515.
62 *Heilbronner*, 100 F. (2) 379.
63 Sec. 22 (b) (2), I.R.C.
64 *Bodine* v. *Com.*, 103 F. (2) 982.

The whole problem of cancellation of indebtedness is too complex for complete coverage at this session. Sometimes these transactions unexpectedly create taxable interest income. In one case[65] a corporation borrowed money from a stockholder who later cancelled and forgave the interest after the principal had been paid. Since the corporation had deducted the interest as it accrued, the Commissioner thought somebody had income from the cancellation. The Board of Tax Appeals thought the stockholder received it constructively, but the Circuit Court held that the corporation received income when the debt was cancelled. However, the *American Dental* rule,[66] will prevent taxation of interest in many cases of gratuitous cancellations.

Interest paid without legal obligation is a gift and therefore not income.[67] But if state law or agreement with beneficiaries requires interest to be paid on a legacy because of delay in distributing corpus of an estate, it is taxable as interest income to the beneficiary and is not a tax free bequest.

Corporate taxpayers have a problem on occasion of determining whether income from securities constitutes interest or dividends. While it makes no tax difference to individuals, proper classification is important to corporations because of the credit allowed to them against dividends received. It is beyond the scope of this paper to examine the factors considered by the Courts in classifying such "hybrid" securities, but in view of current discussions on amendments of the tax law to allow some kind of credit against dividend income of individuals, it may be well for such taxpayers to inquire now into the nature of some of their investments. Those interested might refer to the recent *Bowersock* case[67a] for an illustration of some of the ramifications of this problem.

A final example of the necessity of determining what receipts are truly interest concerns the liquidating mortgage method of financing real estate now in common use. Under this popular plan, the mortgage is liquidated by equal payments over its life. Each payment consists of interest and amortization of principal, the interest element growing gradually less in amount. Obviously only the interest element is taxable, and a careful record should be kept of the diminishing balance of the principal debt.

Now we come to the final type of situation in which the person actually receiving interest may not be the taxpayer required to report the income. It is many years since Justice Holmes enunciated the now established rule by the often quoted phrase that in income tax the fruits may not be attributed to a different tree from that on which they grew.[68] Applying the theory specifically to our specific subject of interest, it may be stated as a general rule that interest paid on a security or debt is taxable income to the creditor no matter who actually receives the funds.

The difficulties with respect to interest bearing securities fall into definite patterns. First, it is clear that if the security itself is transferred, future income thereon is taxable to the donee. But if the transfer was not complete, in that the donor retains major incidence of ownership or enjoyment of the fruits of ownership, the transfer may not be recognized so far as taxation of the income is concerned. It is beyond the scope of this paper to discuss the interrelated problems of gift and income taxes created by such transactions which may be effective under state law but ineffectual for income tax purposes.[69] It may be pointed out, however, that decision that a gift was ineffective for income tax purposes does

[65] *Mallinckrodt*, 38 B.T.A. 960; *Jane Holding Corp.*, 109 F. (2) 933.
[66] *American Dental Co.*, 318 U. S. 322.
[67] *Chase*, 19 B.T.A. 1040 (A).
[67a] *Bowersock*, T.C. memo, Docket 9186, 10/16/47.
[68] *Lucas* v. *Earl*, 281 U. S. 111.
[69] See *Sewell*, Ct. Claims, 10/6/47.

not automatically relieve the parties from gift tax liability.

Second, is was noted above that interest accrued after a valid and effective transfer will be taxable to the donee. But income accrued up to the time of the gift will be taxable to the donor when it is realized even if the donor is on the cash basis.[70] In the cited case so holding, the taxpayer made gifts to her children of notes due from her husband at a time when little interest had been paid for the past eight years, and there was no expectation of additional payments of either principal or interest. During the same year the husband died, and his estate made a substantial payment of interest to the children. It was held that the wife, on the cash basis, realized taxable income in the amount of interest paid.

Third, with respect to securities, the problem can arise of a gift or assignment of the rights to the income, separately from the principal debt. In the celebrated *Horst* case[71] the taxpayer made a gift of interest coupons, but retained ownership of the bonds. The Supreme Court held the donor to be the taxpayer when the coupons matured, on the theory that he obtained the benefit and enjoyment of the fruit by being able to dispose of it. In the *Horst* case the coupons which were the subject of the gift matured in the same year as the gift. The problem of taxation when the coupons assigned mature in later years cannot be regarded as settled. The Board of Tax Appeals in one case held that a cash basis taxpayer does not realize income at the time of gift of accrued but unpaid interest which is not collected until a later year,[72]and in another case[73] it held that income was not realized by the donor upon receipt by the donee of the interest in a later year. But in this latter case it was shown that the debtor was unable to pay the interest at the time of the gift, which distinction was taken by the Tax Court as a basis for its contrary position on the problem.[74]

Under the circumstances, it would seem prudent to avoid gifts by assignment of uncollected and future income. A gift of cash could be used to purchase unmatured bond coupons which would enable the bond holder to secure immediate accrual of taxable income even on coupons maturing in future years.[75] This possibility of anticipating income might be of considerable tax advantage. Presumably the income would be capital gain so far as the unearned portion of the interest is concerned.

Prior to 1942, accrual of all income was required in the final individual return of a decedent, even if he had been on the cash basis. The 1942 amendments provided for continuance of the accounting method previously used. Thus if the decedent were on the cash basis, interest on his securities received after the date of death is income to whoever actually receives it. It retains its character as interest despite the fact that it is received as a beneficiary of an estate. To avoid duplication of tax, the recipient is allowed an offset against such income for estate tax attributable thereto.[76]

IV—Period of Taxation of Interest Income

Much of what has already been said suggests problems and cautions as to the period of taxation of interest income. The whole principle of amortization, of course, is an adjustment of the actualities of receipt to the concept of earnings ratably over a period of time. But there still remain some problems to consider involving solely

---

[70] *Austin* v. *Com.*, 6 T.C. 593, aff'd., 161 F. (2d) 666; cert. den., 10/13/47.
[71] *Helvering* v. *Horst*, 311 U. S. 112.
[72] *Colby*, 45 B.T.A. 536.
[73] *Timkin Estate*, 47 B.T.A. 494; aff'd., 141 F. (2) 625.
[74] *Anthony Estate*, 5 T.C. 752; aff'd., 155 F. (2) 980.
[75] G.C.M. 2612.
[76] Sec. 126 (c), I.R.C.

the question of in which accounting period the interest belongs—a question which of course can be of considerable tax importance.

The first important consideration is the doctrine of constructive receipt. It is basically true that a cash basis taxpayer does not realize taxable income from any source, including interest, until it is reduced to cash. But the Regulations specifically provide[77] that whether or not they are cashed, bond coupons represent taxable income on their due date, provided they are actually collectible. The same rule applies to savings bank interest credits, and building and loan association credits subject to unrestricted withdrawal. But what then of the situation where only part of the interest is available without restriction? Here the Treasury appears to require treatment as constructive receipt of the unrestricted portion of the accrual;[78] this rule would apply to both cash basis and accrual basis taxpayers. Even if the interest coupons are never reduced to cash, but are exchanged for other property, taxable income is imputed.[79] In one interesting case,[80] a corporation satisfied a bond indebtedness including accrued interest by issuance of stock; the accrued interest which had been deducted in prior years, was held to be income, not to the bondholders, but to the debtor corporation. But here the bondholders were protected by the tax free provisions of the Code, and the financial position of the debtor apparently had been such as to preclude imputing of constructive receipt currently.

A common question, and one, incidentally, which appears to present an opportunity for tax planning, arises in allocation of undesignated payments on a debt to principal and interest. If the debtor makes a designation, then the creditor ordinarily must so treat the receipt. But if no designation is made, the creditor may make one to suit his own circumstances. This rule applies only if there is reasonable certainty that the principal amount will be paid. Thus if a debt plus accrued interest is settled for the principal amount only, no interest income is imputed to the creditor.[81] In a bankruptcy or compromise settlement, payments made, however designated, will ordinarily be ascribed to principal even though accrued interest is settled thereby.[82]

It has been explained previously that, regardless of accounting methods, interest which is doubtful of collection does not accrue for tax purposes. When then is it taxable if it is paid later? This matter was raised in a 1942 Tax Court case[83] which had an added interest in that, besides the majority opinion it had two concurring opinions in which four judges joined, and two dissenting opinions involving three judges. The case involved interest which was omitted from taxable income when it accrued in 1934 because the debtor was insolvent. The debtor became solvent in 1935 and the interest was collected in 1937. The Tax Court held that the interest was taxable in 1937, and both concurring opinions enunciated the rule that under such circumstances an accrual basis taxpayer is put on a cash basis for such an item. On appeal the Circuit Court reversed, and held that the income accrued when the debtor became solvent. The higher court stated the criterion to be the right to receive, accompanied by collectibility.

A special question is posed on the time of accrual of interest on refunds of taxes. The problem of when to account for disputed taxes and related interest has long been a vexing one. However, recognizing a series of court

77 Reg. 111, Sec. 29.42-3.
78 I.T. 3689.
79 I.T. 2258.
80 *Capento Securities*, 47 B.T.A. 691.
81 *John Hancock Mutual Life Ins. Co.*, 10 B.T.A. 736 (A).
82 G.C.M. 2861; *Johnson Locke Mercantile Co.*, 51 F. (2d) 434.
83 *Clifton Mfg. Co.*, 1 T.C. 71, C.C.A.-4, 137 F. (2d) 290.

decisions, the Bureau in a recent ruling[84] clarified its position, so that now tax adjustments in dispute are to be accounted for only when the dispute is settled. Consistent with the rule as to the tax item, related interest payable accrues only when the tax liability is settled,[85] and related interest receivable is income when received, on the cash basis, and when acknowledged as a debt by the Treasury, on the accrual basis.[86] This acknowledgment takes the form of issuance of a certificate of overassessment, or signing by the Commissioner of the schedule of overassessments.[87] Thus if an accrual basis taxpayer receives a refund of interest early in a taxable year, it will be necessary to investigate the date of its allowance to determine whether the interest actually accrued at or before the end of the prior year. But if the refund were sufficiently large to require approval of the Joint Committee on Internal Revenue Taxation, accrual would not ensue until the time when the Treasury is permitted to make the refund, if the controversy were still open.[88] Incidentally, it should be noted that interest on refunds of Federal or State taxes is fully taxable, and is not exempt as interest on a government obligation.[89]

Mention has already been made of the problem of determining interest income from condemnation awards. Even if the amount taxable as interest income is uncontested, difficulties as to time of taxation to accrual basis taxpayers can arise. In one case[90] the taxpayer received in one year a payment representing 10% of the principal amount of the award plus interest to date on the entire award. The court held that the interest accrued ratably from the date of the condemnation, so that only the portion accruing from the beginning of the year of receipt was taxable in that year. In another case[91] the taxpayer also received interest on a condemnation award several years after the date of the condemnation. In this latter case, the Court held the entire amount of interest taxable in the year received, for the reason that it was in that year that the final court decree on the condemnation was entered. Thus the philosophy of deferring accrual when the entire transaction is in controversy was applied, as in the tax controversy matter. Clearly under such circumstances taxpayers should protect their positions either by deferring reporting of interest for tax purposes, or by filing claims for refund for earlier years so that all years involved can be reviewed and adjusted at the same time.

A final problem of time of tax reporting concerns the accrual basis taxpayer who owns a debt security all or part of the interest on which is payable only if earned and then only at the option of the debtor. In a ruling[92] on such a security, the Treasury held that interest accrued prior to purchase of the security is a return of capital when payment was authorized, and interest accrued after purchase is income when authorized to the extent not previously reported as income. This is a liberal and reasonable ruling, but nevertheless since it was made on a specific set of facts, taxpayers would be well advised to defer accrual of unpaid interest on similar types of obligations, or to take steps to prevent closing by limitation of prior years in which such uncollected interest was reported, until the whole amount of interest tc date has been declared.

---

84 G.C.M. 25298.
85 G.C.M. 9575.
86 I.T. 2210.
87 *Household Products, Inc.*, 24 B.T.A. 594 (N A).
88 See *Ohio Oil Co.*, U. S. (D C), 36-2 U S T C 9415.
89 *Stockholms Enskilda Bank*, 293 U. S. 84; *Williams Lord Co.*, 31 F. Supp. 154.
90 *Williams Lord Co. (supra.)*
91 *Winter Realty & Construction Co.*, 2 T.C. 39.
92 I.T. 3689.

I Married a C.P.A.

Anonymous

Some women marry explorers and go to darkest Africa and get their pictures taken in kodachrome for The National Geographic Magazine. Others marry foreign correspondents and go off to write gay, lilting tales of life abroad. Then there are the women who marry diplomats and doctors and make their lives sound like one crucial incident after the other. But none can compare with the adventures that befall those of us who marry into the chosen profession, the gift to the business world and to American womankind—the C.P.A.!

We may not go over Niagara Falls in a barrel, but apart from the usual domestic and spiritual upheavals occasioned by the approach of the Ides of March, life with a C.P.A. supplies its own particular adventures and crises. For instance, there was *The Adventures of the C.P.A. in Sheep's Clothing*, or a reasonable facsimile. My C.P.A. wore small patterned foulard ties: red background and black diamonds for the oxford gray suit with the bookkeeper-slouch shoulders and the almost indiscernible blue stripe eight inches apart; brown background for the appropriate dark brown suit; and so on. All of this was topped off by a pair of rimless glasses, lending the proper touch of dignity and conservatism that is such an indispensable part of the accountant's professional appearance. Can you picture the feeling of pride I felt when I finally saw my C.P.A. dressed in a glen plaid suit with an infinitesmal drape, a hand-tied bow-tie, gazing at the world about him through a pair of horn-rimmed spectacles (genteel-looking glasses, but horn-rimmed just the same)? I should confess, though, that it was with a feeling akin to that of Frankenstein's creator that I saw the latest pair of horn-rimmed glasses he chose, and the newest dynamic (to put it politely) addition to a tie-rack that blazons forth with an almost oriental-like splendor. (Note—As a result of a recent sartorial survey conducted by me at a meeting of the New York State Society of C.P.A's., I am pleased to announce that the change in the membership's clothing habits appears to be one of the most overwhelming examples of recent progress in the accounting field.)

> *"Oh wad some power the giftie gie us*
> *To see oursels as others see us!*
> *It wad frae monie a blunder free us,*
> *An' foolish notion."*
>
> —Robert Burns
>
> The writer of this little article, who has chosen to remain anonymous, is the wife of one of our members. With tongue in cheek, she reveals some of our foibles and weaknesses, as she moves on cleverly to the final dénouement.
>
> The editor challenges you to show this article to *your* wife!

Do you know what you are missing if your husband gets all his professional mail at the office? There are the endless CCH reports, some of which are marked "Important — Latest Market Survey" (the postman has stopped ringing the bell frantically when he sees them); the financial statements of all sizes, colors, descriptions and companies, most of which have a certain beauty from an aesthetic point of view, but make very dull reading; the white envelope containing *The Accountants' Weekly Newsletter;* the *Journal of Accountancy*, with a nice new printing job, but perhaps they should vary the color of the cover each month in the same fashion that *Harper's* does; all the notices, literature and magazines from the New York State Society, plus the rhythmic sounding lists of people

who passed the examination, who wish to become associate members, who become associate members, who wish to become full members, and who are raised to full membership. These are placed on the desk each morning, and each evening we make room for the collection of literature my husband doesn't get a chance to read at the office and so brings home. There are the Prentice-Hall service reports, *The Tax Magazine, The Comptroller,* the innumerable booklets put out by Merrill, Lynch, Pierce, etc. (more familiarly known in our house as "We, the People"), SEC releases and bulletins, Research Institute of America surveys in blue and white covers that do not match our décor. Once a month, I carefully arrange all this material in size places. Once every three months I issue an ultimatum — either that desk gets cleaned off, or else—and still the piles stretch skyward *ad infinitum.* Who's henpecked?

Our bookshelves are enlightening, too. Next to a beautiful edition of *The Count of Monte Cristo* is a copy of *Fraud, Its Control Through Accounts.* Fjeld and Sherritt have found refuge among Thomas Mann's volumes on *Joseph.* Kester seems to be supporting *Take It Easy Before Dinner* (a new approach to cooking), and I have found that Holmes on *Auditing* and Neuner on *Cost Accounting* provide the perfect backbone fore and aft for the best collection of paper-backed mystery stories in a radius of three blocks. *Estate Accounting and Taxation* waits expectantly near *The Decline and Fall of the Roman Empire,* while *Practical Budget Procedure* droops dejectedly next to *First Aid for the Ailing House.* If there are empty spaces on your shelves, despair not! Comes the next tax law revision and you can, with no difficulty at all, cajole your husband into bringing home the forty-three interpretations of the aforesaid revision that he has undoubtedly received. Never, never throw out this collection because it may come in handy when one of the Federal, state, and city tax forms, collected since 1918, may be used!

But let us be open-minded. Let us look at it from the other point of view: At least once a year, when things are not quite so hectic in the profession, comes a familiar glint in my husband's eye. The next day he usually appears with a present for me—a new variation of a budget book. We thereupon enter upon a period of carefully noting all expenditures. After two weeks of this, I'm told I can drop all the pennies and round off the figures. One week thereafter, it becomes apparent that I use too many classifications and, instead of headings like Presents to Close Relatives, Presents to Relatives Once Removed, and Tips to Oil Delivery Man, Grocer and Fruitman, I can use something simple—like Miscellaneous. After two weeks of this, it is quite easy to see that the bulk of our expenditures fall naturally into the Miscellaneous grouping, and the budget book soon dies a natural death. I have a wonderful plan for never being short or over while the plan is in use. Just work back from what you have left!

Next, to my shame, come the checkbook manipulations. Because my husband used to spend a good deal of time out-of-town, the chore of balancing the checkbook was mine and I was strictly on my own. Then came the time I was rash enough to admire a man who made out checks and never filled in the stubs or entered deposits. An ideal situation, I said. From that day on, I have been most carefully audited.

"What is this adjustment for $2.34 at the end of the month?" I am asked.

"Oh, my balance didn't agree with the bank and they never make mistakes, so I adjusted." Now I know that it is a fundamental principle of auditing that even a penny error in cash must be carefully checked because it might cover a defalcation of $452,693.88! But this is *our* checkbook.

"You mean you didn't even look for the error?" said my C.P.A. in a tone of rising horror and incredulity.

"Oh," I answer fliply enough, "I know what the $2.34 is. I always make errors in addition of two. That's the two dollars. The thirty-four cents must have been a transposition. Yes, I know that transpositions are usually divisible by nine, but then I must have made another error in addition of two cents and that explains the three and four which equal seven, or nine minus two. So you see, I really didn't have to spend time looking for the error."

I do not recommend this as an ordinary diet, particularly if your husband is subject to the accountant's occupational disease of ulcers. But if you are patient enough, there will yet come the day when your husband makes out checks and does not even take the trouble to enter them. Don't turn the screw then, mesdames!

I always fill in the check stub carefully. "Butcher—$27.86." "No, dear, it is not for two months—didn't you know that the cost of living went up again? Yes, dear, the household allowance should be sufficient, but I lent Elsie eight dollars and then I bought that lovely ashtray for six dollars. Of course, Elsie returned the eight dollars, but I didn't have enough cash for the butcher anyway; so I made out a check for the whole amount. No, I don't have any money left—I had my hair done; and then your whole family stayed to dinner and killed off that roast." Why do C.P.A's. wear that harassed look?

If that doesn't help, there is always the exchange check deal: "Sister—exchange—$40.00" is what the check stub says. The deposit side says "Sister—exchange—$15.00". Don't ask me to explain further, because it is all so abundantly clear; or isn't it?

After we saw "Life with Father", I subtly reminded my husband that apparently a wife's financial failings were not unusual and were, in fact, like women drivers, if you know what I mean.

My husband not so subtly summed up the entire situation when he regarded me with a baleful eye over those frightening glasses and succinctly said, *"Yes, but Father wasn't married TO a C.P.A."*

New York State Tax Clinic

Conducted by Benjamin Harrow, C.P.A.

The Unincorporated Business Tax

A joint venture is formed to buy out a going concern for the purpose of liquidating it. The liquidation proceeds for a period of five years, after which all the assets are disposed of except a life insurance policy on the life of one of the officers of the former business. The joint venturers continue paying the premium on this policy for about eight years. That is the only activity of the joint venture. The officer dies and the joint venturers collect the proceeds of the policy. *Query:* Are the proceeds of the policy subject to the Unincorporated Business Tax?

The unincorporated business tax is levied on the carrying on of a trade or business. Generally the liquidation of a business is not deemed to be the carrying on of an unincorporated business. The official questions and answers state that if a business is to be carried on by a legal representative in substantially the form in which it was conducted by the owner, the legal representative is held to be carrying on an unincorporated business. If the legal representative liquidates the business by selling the assets, distributing the proceeds and winding up the affairs of the business, he is not engaged in carrying on an unincorporated business. Transactions of an isolated or incidental nature usually indicate activities that are not held to be carrying on a business whereas continuity, frequency and regularity of activities spell out the doing of taxable business.

It might be said that the joint venturers were engaged in the business of liquidating a business. That was the purpose for which they were investing their capital. Within the scope of the liquidation operations, which lasted five years, there was continuity, frequency and regularity of activities. The Tax Commission would probably hold that the liquidation operations were subject to the Unincorporated Business Tax. The payment of the premiums on the life insurance policy would probably be construed as a capital investment and the proceeds of the policy, while taxable income, would not be subject to the Unincorporated Business Tax.

* * *

A partnership has been engaged in business for a number of years and has been subject to the Unincorporated Business Tax. At the end of its then fiscal year the partnership is dissolved and the business continued only for the purpose of liquidation. During the following fiscal period the liquidation activities result in some profit, in addition to which the liquidator received some income resulting from prior years' activities when the firm was en-

Benjamin Harrow, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

gaged in business. *Query:* Is any of the income during the current fiscal period subject to the Unincorporated Business Tax?

The liquidation of the business takes it out of the scope of unincorporated business subject to tax, as indicated in the previous discussion. The liquidation profits would be subject only to income tax and the income resulting from prior years' activities would likewise not be subject to the Unincorporated Business Tax these being isolated or incidental transactions.

New York City Business Tax—Taxable Receipts

Under the gross receipts tax, the carrying on of business within the city is subject to tax at the rate of 1/5 of 1%. Not all receipts are included in the tax base. Some receipts are nontaxable because they arise from activities not carried on within the city. Other receipts are deemed to be partly from activities within the city and so are allocable to New York in accordance with a formula that gives recognition to the fact that the receipt arises in part from activities carried on without the city.

The Special Deputy Comptroller recently (August 20, 1948) ruled on the taxability of receipts arising from a source of supply without the city. The shipments were first delivered to a railroad terminal without the city for delivery in some cases to New York City and in other cases to points outside New York City.

In the first situation both the seller and the buyer are located in New York City. The shipment is made by a third party from a source of supply outside the city. The title passed to the buyer at Weehawken, N. J., where a railroad car was released to the purchaser's order. Since the ultimate destination is intended to be at the place of business of the purchaser in New York City, the receipt is wholly taxable to the seller.

In the second situation with the seller and purchaser both located in New York City, the seller makes a shipment from a source of supply outside of New York to Weehawken, N. J., where title passes to the purchaser. The ultimate delivery is to a foreign customer. Such a receipt constitutes a receipt from sale in foreign commerce and is entirely nontaxable. The opinion of the Deputy Comptroller states that the goods must be properly packed and marked for export at the third party's out of city source of supply. The receipt would be entirely nontaxable, even if delivery were made by the third party to a ship docked at a New York City pier.

In a third situation the seller is located in New York and the buyer in New Jersey. As in the first case the shipment is made to the purchaser at Weehawken where title passes. If the ultimate destination is intended to be at the place of business of the purchaser in New Jersey the receipt is nonallocable, and a nontaxable receipt.

A corporation has a business office in New York and its manufacturing plants outside New York. Its products are sold by shipping the merchandise from the out of state plants to customers in New York City, New York State and other states. The corporation organizes two wholly owned selling subsidiaries. One subsidiary has only a New York office. The other has offices in New York City and other places. The corporation sells its products to the two subsidiaries, title passing at the plant of the parent company. *Query:* Does the sale to the subsidiary affect the gross receipts tax? The Deputy Comptroller indicates that under the gross receipts tax the corporate entity is not ignored even though the various companies constitute one unitary business. Each company is a separate taxable entity. Under the facts the receipts of the parent company arising from sales from out of state plants to New York City customers of the two subsidiaries would

be allocated as partly within the city and partly without. Receipts arising from sales to New York State customers and out of state customers would be nonallocable and nontaxable. In addition the subsidiary companies would be taxable on the deliveries made by the parent company to the New York City customers of the subsidiary companies. The subsidiary companies would of course not be taxed on the receipts arising from the out of state sales of the subsidiary companies. The transfer of title at the plant of the parent company is immaterial.

Federal and New York Tax Differences—Personal Exemptions and Credits

Under the Internal Revenue Code, a taxpayer receives a normal and surtax exemption of $600 for himself and an additional $600 for his or her spouse if a joint return is filed. The taxpayer is also entitled to the additional $600 if separate returns are filed, provided the spouse has no gross income and is not a dependent of any other taxpayer.

Under the state law a single person receives a personal exemption of $1,000. A head of a family is entitled to a personal exemption of $2,500 and a married couple receive an exemption of $2,500, which may be divided between them as they determine. The federal law no longer has any status of head of family.

Under the Internal Revenue Code a taxpayer may now take a credit of $600 for each dependent provided the gross income of the dependent is under $500. The dependent must be closely related and there is no longer any age limitation for the dependent. Under the state law the credit for each dependent is $400, the dependent must be physically or mentally incapacitated or under 18 or in attendance at school, if over 18.

Under the Internal Revenue Code the marital status for personal exemption or credit for dependents is determined as of the last day of the taxable year or as of the day of a spouse's death. There is no proration because of a change in status. Under the state law the personal exemption and credit for dependents are prorated if there is a change of status during the taxable year.

Under the Internal Revenue Code there is a special $600 credit if a taxpayer or his spouse is 65 years of age or older. In addition there is an additional exemption of $600 for a taxpayer who is blind as that term is defined in the law. The state income tax law has no similar provision with respect to old age or blindness.

The New York State tax law allows estates and trusts a specific exemption of $1,000. The federal law allows estates $600, and trusts only $100 as exemptions.

Basis of Tax—Federal and New York State Differences

Under federal law it might be said that the basis of the tax is net income and this includes net capital gain. A distinction is drawn under federal law between long-term and short-term capital gains and losses. Under state law net capital gains are separately computed and separately taxed at half the rates applicable to ordinary income. No distinction is made between long and short term capital transactions. To the extent of $1,000 a net capital loss may be offset against ordinary income under federal law. Under state law ordinary income may not be offset by any part of a net capital loss. However a net capital loss may be carried over for five consecutive years until fully absorbed by net capital gains.

Under 1948 amendments to the Internal Revenue Code the income of husband and wife is taxed as if it were divided equally between them. No such income splitting is as yet permitted under state law.

Section 107 Income

If at least 80% of the total compensation for services performed over a period of at least 36 months is received in one year, the tax on this income for the year in which it is received may not exceed what it would have been if the income had been received ratably over the period during which the services were performed. It is surprising that the state has not as yet introduced a similar provision in the state income tax law. Under state law such income would be taxed in full in the year of receipt, the taxpayer being on a cash basis.

The Taxation of Stock Dividends

Under state law all stock dividends are exempt from tax. Under federal law a stock dividend may or may not be construed as income. If the resulting interest of the stockholder is in any way altered he is in receipt of taxable income. Otherwise he is not. This has resulted in considerable litigation. The state rule has the advantage of simplicity in administration. Of course the receipt of a stock dividend results in an adjustment of the basis of the old stock in determining subsequent gain or loss and in the process the new stock received acquires a basis for gain or loss. Under the state law the rule with respect to stock dividends applies regardless of the classification of the stock.

Recovery of a Bad Debt

Generally, recoveries result in taxable income under both state and federal law. Under the tax benefit rule however, a recovery is not taxed as income if the taxpayer did not receive a tax benefit by reason of the deduction for the bad debt in a prior year. Under the state law the tax benefit rule has a limited application. The recovery is taxable as income unless during the prior three years the deduction for the bad debt did not result in a tax benefit to the taxpayer.

Deduction for Medical Expenses

Under the 1948 amendments to the federal law the maximum deduction for medical expenses may now be $1,250 to $5,000, depending upon the number of dependents. For a husband, wife and two dependent children this deduction may be as much as $5,000 on a joint return. Under state law the medical expense deduction may not exceed $750 for a single taxpayer and $1,500 for a married couple or for a head of a family. Only medical expenses in excess of 5% of adjusted gross income are deductible under the federal law. Under state law medical expenses up to 5% of net income computed before deducting medical expenses or contributions are not allowed as deductions.

Insurance Premiums

Under federal law personal life insurance premiums are nondeductible personal expenses. Under state law such premiums may be deducted from gross income up to a maximum of $150.

Wash Sales and Sales Between Related Persons

A reacquisition of substantially identical stock within thirty days before a sale of such stock or within thirty days after such sale is treated as a wash sale and a loss resulting from such sale is not allowed as a deduction. The state law has no specific provision with respect to wash sales and such a loss would be recognized.

Losses resulting from sales between members of a family, between controlled corporations, between an individual and a controlled corporation are not allowed as deductions under federal law (sec. 24c). Under state law all such losses would be allowed unless the transactions were not made in good faith.

Optional Standard Deduction

Under the 1948 amendments to the federal law the amount of the standard

deduction which may be taken in lieu of itemized deductions has been modified. If adjusted gross income is over $5,000 the standard deduction is $1,000 or 10% of adjusted gross income, whichever is less. If husband and wife file separate returns, each spouse is entitled to a maximum standard deduction of only $500. If adjusted gross income is less than $5,000 the standard deduction of 10% is automatically considered in the Supplement T Tax table.

Under state law the optional deduction is 10% of gross income with a maximum of $500, and is in lieu of all other deductions including business expenses. This deduction covers husband and wife living together. If separate returns are filed the $500 may be taken by either spouse or divided between them. Both spouses must use the optional deduction if one elects to do so.

Deduction for Taxes

Bridge tolls are not tax payments and therefore are not deductible under Sec. 360(3) which allows a deduction for taxes in computing net taxable income. If the toll is connected with a trade or business or with the production of taxable income, it may be deducted as a business expense. The State Tax Commission has so ruled under date of August 17, 1948. A taxpayer who commutes to his place of business and uses toll highways must thus treat the toll as a personal expense.

Bad Debt Reserves Under Art. 9B or 9C

The State Tax Commission has adopted the moving average basis for the determination of a bad debt reserve for banks and other corporations taxable under Articles 9B or 9C. On December 8, 1947, the Commissioner of Internal Revenue had issued a ruling (Mimeograph 6209) permitting the use of this method in the case of banking corporations. The ruling was effective for the year 1947. In the April issue of the State Tax Clinic (p. 313) we commented on the Commissioner's ruling. It was hoped that the Tax Commission would adopt a similar ruling and in its usual spirit of cooperation, it has done so.

The franchise tax return for banks is due September 1st, but in view of the issuance of the new ruling on September 10th a blanket extension of time for filing the franchise tax return was granted to October 15, 1948. The election to use this reserve method must be indicated by a written statement explaining in detail the computation of the bad debt deduction. As mentioned in the April issue, the moving average reserve requires first the determination of the ratio of bad debt losses to outstanding loans for a twenty year period including the current year which would be 1947. This ratio is then applied to total loans at the end of 1947 and the resulting amount becomes the reserve for the first year that may be charged against income as a deduction. For 1948 the twenty year average ratio is again established including the 1948 year but excluding the first year used in setting up the 1947 ratio. The new ratio is then applied to total loans at the end of 1948 and the result becomes the addition to the reserve for bad debts. The reserve may not exceed three times the moving average at the end of any year. Actual bad debts are charged against the reserve and recoveries are credited to it. The purpose of the reserve accumulations is to provide a cushion for the absorption of bad debt losses in deficit years.

When Are Additional State Franchise Taxes Dedubtible?

In the June, 1948, issue of the Tax Clinic (p. 457) we noted that an additional state franchise tax was deductible for franchise tax purposes in the year following the year in which it is paid. Our note was based upon a letter from the State Tax Commission to one of our members.

Sidney Roberts reports that recently

he has had some correspondence on this issue and he has been informed that a taxpayer may deduct additional taxes assessed for prior years in the year that they are paid provided they are taken as a deduction in filing the federal tax return. If they are not taken as a deduction in such year the Tax Commission permits the deduction in whatever year they are allowed as a deduction by the federal government.

This treatment of the deduction would seem to be different from the one previously approved by the Tax Commission as noted in the June issue.

Valuation of Stock in a Closely Held Corporation for Estate Tax Purposes

The usual method of determining the value of stock in a closely held corporation for estate tax purposes is on the basis of the book value of the stock plus a valuation for good will if there is any. The State Tax Commission thus requires the submission of balance sheets and profit and loss statements for a five year period to enable it to make a proper determination of the value of the stock.

It is quite common for a stockholder to enter into a stock purchase agreement with his associate stockholders providing for the purchase of his stock by the surviving stockholders at a specified price which may be and usually is less than the book value of the stock. May such stock be included in a decedent's estate at such contract price on the ground that such price establishes the market value of the stock for tax purposes? That was the issue before the Surrogate in Estate of H. Tyler Miller, deceased.[1] The Surrogate held that the stock purchase agreement established the market value of the stock. The agreement had been entered into in good faith and the estate of the deceased stockholder was bound to sell the stock at the specified price. The Surrogate points out that under the federal estate tax law such agreements establish the market value of stock in closely held corporations and the federal decisions may be accepted as good authority for the New York Estate tax law which is similar in this respect.

There was a second issue in this case. Under the stock purchase agreement the stock was valued at $104.50 per share. Under the method of computation employed by the State Tax Commission the stock was valued at $128.34 per share. The agreement was entered into two days before the stockholder died. The State Tax Commission contended that the difference of $23.84 per share (547 shares were involved) represented a gift in contemplation of death. On that issue the Surrogate held that the evidence showed that the agreement was not made in contemplation of death but for the mutual protection of all the parties to the agreement.

New President of State Tax Commission

Spencer E. Bates has been named President of the State Tax Commission. This is gratifying news. No one man now in the department has done more to build up an administrative body that measures up to the importance of New York State than Commissioner Bates. He has been a cooperative friend of the accounting profession and of our Society. We have welcomed him often at our meetings of which he has been a vital part. He has our best wishes for a continued successful career as a State administrator and he can be assured of the continued cooperation of our Society.

The appointment of Allen J. Goodrich to the Tax Commission has also been announced. To him, too, we send our best wishes.

[1] Surrogate's Court, Monroe County, May 24, 1948

Accounting at the S. E. C.

Conducted by William W. Werntz

Practice before S.E.C.

As a part of its statistical work, S.E.C. publishes a variety of corporate financial data that has been filed in annual reports under the 1934 Act by companies which have securities listed on the national securities exchange or which, though not listed, have registered a substantial volume of securities under the 1933 Act. These statistical studies are termed the "Survey of American Listed Corporations" and the data published is announced in a special "Survey" series of releases. Of particular interest to accountants is a recent release in this series (Number 137) which classifies accountants practicing before it according to the number and size of registrants whose financial statements the accountant examines. The release is worth quoting in full:

> "Financial statements of 2,265 registrants* with aggregate assets of 100 billion dollars, filing annual reports with the Securities and Exchange Commission under the Securities Exchange Act of 1934 and the Securities Act of 1933 were certified by a total of 416 independent public accounting firms.
>
> "Compared to the average of about 5 registrants per accounting firm approximately two-thirds of the 416 accounting firms certified statements for only one registrant, while on the other hand, there were 7 accounting firms who certified statements ranging from 81 to 247 registrants each. These 7 accounting firms certified the statements of more than 56 percent of all registrants covered in the survey. On the basis of total assets these 7 accounting firms certified the statements of registrants whose assets amounted to 80 billion dollars. The data as to certification by accounting firms is shown more fully in the following table.

William W. Werntz, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C.P.A's.

Mr. Werntz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Werntz is the author of numerous articles which have appeared in technical accounting publications. He is Vice-President of the American Accounting Association.

"ACCOUNTING FIRMS CLASSIFIED BY AGGREGATE ASSETS OF REGISTRANTS SERVED

(Dollar Figures in Billions)

	Aggregate Assets of Registrants Served	Number of Registrants	Number of Industry Groups Covered	Percent of Total Number of Registrants
1............	$24.6	247	101	10.9
2............	15.0	188	79	8.3
3............	13.2	184	69	8.1
4............	11.0	206	99	9.1
5............	6.0	236	92	10.4
6............	5.3	81	53	3.6
7............	5.0	130	83	5.7

"The following table shows the number of accounting firms certifying to ten different groups of registrants and the aggregate assets of each group.

Number of Accounting Firms	Certifying to	Aggregate Assets of Registrants (Billions of Dollars)
3	200 or more companies	$41.6
3	100 to 200 companies	33.2
2	50 to 100 companies	6.8
2	25 to 50 companies	2.4
11	10 to 25 companies	8.5
28	5 to 10 companies	3.3
12	4 companies	0.5
18	3 companies	0.4
58	2 companies	1.6
279	1 company	1.9
416	2,265 companies	$100.2

* These figures relate only to the registrants themselves. Information on subsidiaries that were not registrants was not available. The assets of registrants that were consolidated subsidiaries of another registrant are included in the assets shown and reflect some overstatement in these cases."

Seaboard Commercial Corporation

On September 3, 1948, S.E.C. issued its order suspending trading in stock of Seaboard Commercial Corporation on the Baltimore Stock Exchange. Such order of suspension also had the effect of making it unlawful for brokers and dealers to make use of the mails or any other instrumentalities of interstate commerce to effect transactions in the over-the-counter markets. The following release (Securities Exchange Act Release No. 4170) was published on expiration of the above orders:

"Upon the expiration on September 26, 1948 of the Commission's suspension order, exchange trading in these securities will continue to be suspended by independent action of suspension by the Baltimore Stock Exchange on September 3, 1948, pursuant to the provisions of the Commission's Rule X-12D2-1(a), but the prohibition upon over-the-counter trading resulting from operation of the Commission's Rule X-15C2-2 will not be applicable after September 26, 1948. The Commission deems it necessary and appropriate in the public interest and for the protection of investors to make public such information as is presently available with respect to the financial condition of Seaboard and its affiliated corporation, Long Island Bankers Corporation, in order to avoid violations of the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 which otherwise might result from further transactions in securities of these corporations after expiration of the prohibition upon over-the-counter trading.

"In Release No. 4160 the Commission announced the receipt from Mr. Robert P. Babcock, president and director of Seaboard, of a copy of a letter which he addressed to the Baltimore Stock Exchange that stated in part as follows:

'Current investigation by industrial engineers and special accountants of the assets and affairs of the customers of Seaboard, although presently incomplete, indicate that the customers are not in a position, at this time, to pay any substantial portion of their obligation to Seabard and that in the absence of additional available funds sufficient to enable customers to continue operations, the presently estimated and foreseeable recoveries on these accounts will be inadequate to enable Seaboard to meet all of its existing bank obligations. In the light of these facts. Seaboard's banks have refused to extend further credit to the corporation and have expressed the view, that steps be taken to liquidate the customers' accounts.

'Under the circumstances, there would appear to be serious question as to whether or not the stock of Seaboard Commercial Corporation has any value.'

"The balance sheet of Seaboard prepared as of December 31, 1947, by Touche, Niven, Bailey & Smart, certified public accountants, and filed by Seaboard with the Commission on June 1, 1948, indicates that Seaboard on December 31, 1947 had total assets of $7,987,317.56, including approximately $6,600,000 in loans to certain other corporations and a wholly owned subsidi-

ary, cash of $775,000, and a claim for tax refund of $500,000. This balance sheet disclosed that Seaboard had current liabilities consisting of unsecured notes payable to banks in the amount of $4,600,000, had a reserve against losses and contingencies of $857,000 and had capital stock and surplus of $2,473,000.

"The same firm of accountants made a survey as of the date of June 30, 1948 of the financial condition of the eight corporations to which Seaboard then had $6,607,901 of its funds outstanding in loans. As a result of that survey, this firm of accountants in its report estimated that as of June 30, 1948 the amount of the reserve that would be required by Seaboard to cover the losses from these outstanding loans would be $4,150,000 under forced liquidation of the debtor corporations, and would be $2,500,000 if the debtor corporations were allowed from one to three years to work out their indebtedness.

"On September 15, 1948, the present acting general manager of Seaboard informed members of the Commission's staff that Seaboard owes $3,450,000 to 13 banks. He further stated that McKinsey & Co., industrial engineers, and S. D. Leidesdorf, certified public accountants, were recently engaged to make another study of the financial condition of the corporations to which Seaboard had loaned its funds, and that in the opinion of these firms Seaboard may realize approximately $1,800,000 from its loans to borrowing corporations, which loans exceed $6,000,000.

"Members of the staff have been informed by representatives of Seaboard that the only asset of Long Island Bankers Corporation, and its sole source of income, is 72% of the common stock of Seaboard; that the principal officers and directors of Long Island and Seaboard are identical; and that Long Island has preferred and common stock outstanding, which until the present time, has been the subject of trading in the over-the-counter securities markets.

"It is the view of the Commission that any broker or dealer who sells or executes a purchase order for either common or preferred stock of either Seaboard Commercial Corporation or Long Island Bankers Corporation will violate the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 (where use is made of the mails or any instrumentality of interstate commerce), unless prior to the transaction he informs the purchaser of the facts stated above, which have an important bearing upon a determination whether the common and preferred stocks of Seaboard and of Long Island have, or may be expected in the future to have, any value whatsoever."

AN ADIRONDACK VIEW

CPArtist. Well, she has gone. As it must to most accountants, the day came when the only child went away from home. Why "the only child"? We are not going to argue the point that the average CPA family consists of one husband, one wife, one child (and one dog).

Yes, our daughter Joyce entered college last month, Syracuse University. (That Syracuse Chapter has everything—even a university.) And do you think that family exposure to accounting lands her in this university where she will be under any tutelage by our distinguished CPA Professor George Bennett? Certainly not! It is Fine Arts for her, none of this mundane adding, subtracting, and multiplying. She doesn't want to limit her pencil pushing to red and black colors, and limit her figures to the ten digits. She will study illustrating.

But, in accord with the philosophy of taking advantage of every defeat, we have already planted the seeds for a great, new, and revolutionary change in accounting and auditing practice. See special bulletin in about 1953. The desire for simpler and more interesting financial reports is constantly being pushed at us. (Yet the public does not make any yell at all about getting medical instructions written in Latin and medical reports, both verbal and written, in six syllable words of Latin and Greek derivation.)

And what is this big idea? Simple, Mr. SEC, very simple. Have our reports illustrated by a competent, independent artist. Think of the fun we would have looking at the final results of 500 man-hours auditing and $20 worth of midnight electricity. Balance sheets with sketches of a lot of little girls on one side, balanced by a few big girls on the other side. Operating statements with profit figures on a mountain peak and loss figures down in the Grand Canyon, all in color, no less.

It won't be long now! The large organizations will have an art department and a CPArtist. And the CPA exam will be one-half day longer to include Accounting Art. Accounting—marches on!!

Leonard Houghton, C.P.A.
of the "Adirondack Chapter"

PROFESSIONAL COMMENT

By Emanuel Saxe, C.P.A.

Postulates of Income Accounting

In the January, 1948, issue of *The New York Certified Public Accountant* our readers were introduced to the current joint project of the American Institute of Accountants and the Rockefeller Foundation on the subject of the terminology and concepts of business income. In a most stimulating article, George O. May, who is the research consultant for the study group, there outlined his personal views as to the probable direction that this inquiry might take.

Once again, in the August, 1948, issue of The Journal of Accountancy, Mr. May presents some tentative observations of his own on these concepts, in the hope that a discussion helpful to the deliberations of the study group may thereby result. His presentation deals with the following two postulates, which he says are neither scientific truths nor even completely rational assumptions, but rather expressions of the best present thinking whose uninterrupted acceptance depends on continued usefulness.

> "Among the standard postulates of accounting today is one that income is 'realized' gain and that, therefore, income emerges when the revenue from which it is derived is realized. A corollary is sometimes assumed that property expected to be consumed or employed in production should never be carried at more than cost.
>
> "Another postulate is often expressed as being that periodical accounts should be computed on a going concern basis, or as I prefer to put it, that in the absence of factors which put a natural limit on the duration of operations, the enterprise may be assumed to have an indefinitely long life."

By means of a series of pointed references and quotations, Mr. May indicates clearly that these postulates are not necessarily immutable. He thereupon proceeds to consider modifications of accounting practice that might reasonably follow from acceptance of such revised concepts as (1) the determination of income in terms of a unit of uniform purchasing power and (2) the lack of material importance of the year-to-year value of the fixed property investments of an enterprise whose life may be regarded as indefinitely long.

Here is a great opportunity for all those interested in accounting theory to exchange ideas on this all-important subject.

Inventory Pricing

Carman G. Blough, C.P.A., presents a summary of the current thinking on this subject by the Committee on Accounting Procedure of the American Institute of Accountants (The Journal of Accountancy; September, 1948).

The paper starts with this basic premise:

> "The inventory at the end of an accounting period is 'in effect a residual amount remaining after the matching of absorbed costs with concurrent revenues.'[1] It represents the 'amount properly chargeable against the revenues expected to be obtained from the ultimate disposition of the goods carried forward.'[2] The primary problem in accounting for inventories, therefore, is that of determining what portion of the total inventory-cost expenditure of the

[1] American Institute of Accountants, Accounting Research Bulletin No. 29, p. 236.

[2] Ibid.

period should be allocated to current revenues and what part should be allocated to future revenues."

It then considers, *seriatim,* the elements comprising inventory cost, the various methods whereby inventory costs should be allocated to accounting periods, the use of market to reflect losses in inventory value at the balance sheet date, problems in applying the "cost or market" rule, and reserves for future price decline.

The author's exposition of the meaning of "market," as laid down in Accounting Research Bulletin No. 29, is one of the clearest statements on the subject which this writer has seen.

Accounting Research Bulletins and the Smaller Practitioner

In a very frank discussion of this problem, A. Frank Stewart voices some of the current thinking on this subject by smaller practitioners (The Journal of Accountancy; September, 1948). He asks such challenging questions as:

"Are Accounting Research Bulletins of any worth to us?

"Are we to be bound by the principles set forth therein?

"If the bulletins have no worth to us, what can we do to make them of value?

"Shall those who consider themselves *not* bound by the bulletins be asked to change their attitude?

"Should the bulletins be ratified or rejected by state societies?"

So important did the Institute regard this expression of viewpoint that it devoted two pages of editorial comment to the paper in the same issue of the Journal. After referring to that portion of the address of George D. Bailey before our Society (see: *The New York Certified Public Accountant;* May, 1948; page 356) which stressed the necessity of a single standard of auditing performance by all C.P.A's., the editorial concluded:

"Double standards, artificial lines of distinction, or unspoken antagonisms within the profession would create a serious danger of disunity which the accounting profession cannot afford. Only as a united, cooperative body can it hope to hold the ground it has won, or to realize its tremendous opportunities for service in the future."

Codification of A.I.A. Pronouncements on Essential Disclosures in Published Financial Statements

After having issued 33 Bulletins on Accounting Procedure and 23 Statements on Auditing Procedure, following the preparation of the basic document, "Examination of Financial Statements by Independent Public Accountants", the Institute's Research Department has compiled an analysis of all references therein to the subject of essential disclosures in published financial statements (Journal of Accountancy; August, 1948).

All interested persons are requested to furnish the Institute's Committee on Accounting Procedure with "their thoughts and suggestions on these and any other questions of disclosure in published financial statements which they consider important."

Auditing Punched Card Records

For over twenty years, C. C. Sparks, assistant to the controller of IBM, has been active in the application of punched card equipment to accounting problems. In an excellent, though brief paper appearing in the September, 1948, issue of The Journal of Accountancy, Mr. Sparks indicates how such equipment may provide internal or independent auditors with an additional tool to speed up certain clerical phases of their examination. Payroll, cash receipts, accounts receivable and inventory comprise the illustrative areas discussed.

The Present Legal Status of Microphotographed Business Records

The author of this most interesting paper (The Journal of Accountancy; July, 1948) is Daniel F. Noll, consultant on microphotography with the National Archives, and a noted authority on the subject. He reviews the

rules of evidence applicable to microfilms as well as the two cases on the subject. He concludes as follows:

"In summary, then, after almost two decades of modern microphotography, legal problems have risen in only two court cases. In both these cases, it is conceivable that no legal issue would have been raised if the fundamental rules of evidence had not been abandoned for short-cuts offered by the regular-entry statutes. Time and legal costs will probably be saved if the following simple precautions are taken:

1. Establish the existence, at one time, of the original and its competency as evidence.

2. Show that the motive for its destruction or non-production in court is free from suspicion of fraud.

3. Establish the accuracy of the microphotographic technique.

4. Follow minutely the statute or case law of the jurisdiction."

Business Interruption Insurance

Another article on the subject of the accountant's role in insurance adjustments is Frank S. Glendenning's "How Accounting Services Determine Loss for Insurance Purposes," in the August, 1948, issue of The Journal of Accountancy.

It deals principally with problems of use and occupancy (business interruption) insurance, and explains the several forms of this type of policy as well as the problems involved in determining the proper amount of coverage to be carried thereunder.

OFFICIAL DECISIONS *and* RELEASES

At a Term of the Appellate Division of the Supreme Court, held in and for the First Judicial Department, in the County of New York, on the 12th day of April, 1948.

PRESENT: HON. DAVID W. PECK, *Presiding Justice,*
" EDWARD J. GLENNON,
" EDWARD S. DORE,
" ALBERT COHN,
" JOSEPH M. CALLAHAN,
Justices.

In the Matter of the Application of

NEW YORK COUNTY LAWYERS ASSOCIATION,
Petitioner-Appellant,

to Punish for Contempt and to Enjoin the Unlawful Practice of the Law by

BERNARD BERCU,
Respondent-Respondent.

631
ORDER

An appeal having been taken to this Court by the Petitioner from an order of the Supreme Court entered in the office of the County Clerk of New York County on April 1, 1947, dismissing the proceeding and the petition to punish respondent for contempt and to enjoin the unlawful practice of law by respondent; and said appeal having been argued by EDWIN M. OTTERBOURG, ESQ., of counsel, for the appellant; by MATHIAS F. CORREA, ESQ., of counsel, for the respondent; and by JULIUS HENRY COHEN, ESQ., of counsel for the New York State Bar Association, amicus curiae; and GRAY WILLIAMS, ESQ., having appeared of counsel for the Association of the Bar of the City of New York, having stated he supported the appellant's points but not having filed any brief herein; and due deliberation having been had thereon, and the opinion of this Court having been filed, it is

ORDERED and ADJUDGED, that the order appealed from be and the same hereby is reversed on the facts and the law, and it is further

ORDERED and ADJUDGED, that the respondent, Bernard Bercu, is adjudged in contempt of the Supreme Court under Section 750 (B) of the Judiciary Law for his unlawful practice of law in violation of Section 270 of the Penal Law, in that as stated in the opinion of this Court, the respondent not being an attorney and counsellor at law, admitted to practice in the State of New York, did on or about the 13th day of August, 1943, offer for compensation to give his opinion to the Croft Company on a tax law problem and to study the law and reported decisions in respect thereto, and thereafter respondent made a study of the reported decisions, examining a score or more of the hundreds of cases on the questions, held conferences with and rendered his written opinion dated August 21, 1943, as well as oral advice to the Croft Company on the questions of law involved, and thereafter on or about December 31, 1943, charged a fee therefor of $500 which was at the rate of about $50 an hour for his time; although respondent was a certified public accountant, he was not being employed as an auditor or accountant for the Croft Company nor to do any work on its books or tax return, and his said services did not consist of any advice as to how its books should be kept or entries should be made, or transactions or figures recorded; and his services arose out of the following particular circumstances, to wit:

In 1943, the Croft Company was considering compromising certain claims of the City of New York for unpaid retail sales taxes and compensating use taxes attributable to business done in prior years, if it were legal to deduct the payment of such compromise on its Federal income tax return for the year 1943, rather than attribute such payment to the years in which the City's claims arose; respondent's services consisted of study and

the giving of legal advice as to what view the tax authorities and ultimately the courts would take as to the years in which the payment of the City's tax claims would be deductible for Federal tax purposes; the problem was submitted to the respondent for his advice based on what he knew of the tax law after the company's regular accountant who was also a lawyer had given his opinion based on a decision of the United States Supreme Court that any such payment would have to be charged back to the prior years; the respondent undertook to find a different answer in the tax law; the action of the Croft Company with reference to the disposition of the tax claims depended upon the advice it got as to the law applicable to the proposed settlement if made; the services rendered by the respondent were described by him on his bill dated December 31, 1943, as being "Consultations in re current taxable year of New York City excise taxes for prior years," and "Memorandum in re above;"

And respondent having admitted that these services to the Croft Company were not an isolated instance of its kind, and that he often gave advice of the character which he gave to the Croft Company without examining books or preparing tax returns, charging as high as $50 an hour for his services as a tax consultant as distinguished from his charge of $15 an hour for auditing, and having thus made it a practice of giving legal advice unconnected with accounting work and apart from the regular pursuit of his calling as a certified public accountant, he has been unlawfully practicing law and assuming to practice law; and that for said contempt respondent, Bernard Bercu, is hereby fined in the sum of $50 and is directed to pay the same to the Clerk of the Supreme Court, New York County, on or before the expiration of ten (10) days from the service upon the respondent of a certified copy of this order with written notice of entry thereof; and it is further

ORDERED and ADJUDGED, that the respondent, Bernard Bercu, be and he hereby is enjoined and restrained from practicing or assuming to practice law in any manner, and in particular, from engaging in and charging for the giving of legal opinions in relation to the tax laws, and in rendering legal services in respect thereto for compensation and for the same purposes, from holding himself out or assuming, using or advertising himself as a tax counsel, tax counsellor or tax consultant, or by any equivalent designation; provided, however, that respondent shall not be enjoined hereby from applying his knowledge of tax laws and regulations in any matter in which he is employed primarily to practice public accountancy as defined by the Education Law of the State of New York, Section 7401 (4) including the preparation of tax returns, requiring such accounting services; nor, as a certified public accountant enrolled as an agent with the Department of the United States Treasury, from performing services in the presentation of a client's interests to that department as authorized by its rules and regulations; and it is further

ORDERED, that the following findings of fact contained in the opinion of the Court at Special Term, that:

"In 1943 the Croft Company made a settlement with the City of New York by which the corporation was to pay the city the sum of $12,000 for city sales taxes for the years 1935, 1936 and 1937 * * *. The question then arose whether under the Federal Income Tax Law the payment to the city in 1943 could be deducted by the corporation from income earned in 1943 or whether such payment had to be allocated to the years 1935, 1936 and 1937." (Fols. 1047-1048)

"The respondent Bercu limited his research and his advice to principles of proper accounting * * *."

"Bercu * * * treated the ruling (of the Income Tax Unit of the Treasury Department) as amounting to what was considered by accountants to be sound accounting practice." (fol. 1100)

be and the same hereby are reversed; and in lieu thereof, this Court hereby makes the findings of fact and conclusions of law as stated in the opinion of the Court, per Peck, P. J., filed herein.

One of the justices dissents and votes to affirm.

E N T E R

D W P

September 24, 1948.

* * *

AMERICAN INSTITUTE OF ACCOUNTANTS

13 East 41st Street, New York 17, N. Y.

October 14, 1948.

TO THE MEMBERS OF THE
AMERICAN INSTITUTE OF ACCOUNTANTS:

GENTLEMEN:

The committee on accounting procedure has reached the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions to meet the problem created by the decline in the purchasing power of the dollar.

The committee has given intensive study to this problem and has examined and discussed various suggestions which have been made to meet it. It has solicited and considered hundreds of opinions on this

subject expressed by businessmen, bankers, economists, labor leaders and others. While there are differences of opinion, the prevailing sentiment in these groups is against any basic change in present accounting procedures. The committee believes that such a change would confuse readers of financial statements and nullify many of the gains that have been made toward clearer presentation of corporate finances.

Should inflation proceed so far that original dollar costs lose their practical significance, it might become necessary to restate all assets in terms of the depreciated currency, as has been done in some countries. But it does not seem to the committee that such action should be recommended now if financial statements are to have maximum usefulness to the greatest number of users.

The committee, therefore, reaffirms the opinion it expressed in Accounting Research Bulletin No. 33, December 1947.

Any basic change in the accounting treatment of depreciation should await further study of the nature and concept of business income.

The immediate problem can and should be met by financial management. The committee recognizes that the common forms of financial statements may permit misunderstanding as to the amount which a corporation has available for distribution in the form of dividends, higher wages, or lower prices for the company's products. When prices have risen appreciably since original investments in plant and facilities were made, a substantial proportion of net income as currently reported must be reinvested in the business in order to maintain assets at the same level of productivity at the end of a year as at the beginning.

Stock holders, employees, and the general public should be informed that a business must be able to retain out of profits amounts sufficient to replace productive facilities at current prices if it is to stay in business. The committee therefore gives its full support to the use of supplementary financial schedules, explanations or footnotes by which management may explain the need for retention of earnings.

Four of the twenty-one members of the committee, Messrs. Broad, Paton, Peloubet and Wellington, dissented from the conclusion that no basic change in the accounting treatment of depreciation of plant and equipment is practicable or desirable under present conditions. They believe further that inflation has proceeded to a point where original dollar costs have already lost their practical significance and that where depreciation is an important element of cost the advantages which would result from a basic change in accounting treatment outweigh the possible disadvantages which have been advanced against it.

For the

COMMITTEE ON ACCOUNTING PROCEDURE

By SAMUEL J. BROAD
Chairman

* * *

STATEMENTS ON AUDITING PROCEDURE

Issued by the

COMMITTEE ON AUDITING PROCEDURE,
AMERICAN INSTITUTE OF ACCOUNTANTS,
13 East 41st Street, New York 17, N. Y.

No. 24 October 1948

Revision in Short-Form Accountant's Report or Certificate

1. The special report of the committee on auditing procedure on "Auditing Standards—Their Generally Accepted Significance and Scope" was issued in October, 1947. The summarized statement of auditing standards appearing on page 11 of the special report was approved in a resolution adopted by the council of the American Institute of Accountants in May, 1948. In accordance with that resolution, the summary of auditing standards was submitted for approval to the members attending the annual meeting of the Institute in September, 1948, and was approved. The resolution adopted by the members present is appended to this statement.

2. The foregoing actions give an official status to the meaning of the term "generally accepted auditing standards" which has been used for several years in the accountant's short-form report or certificate. It is the view of the committee on auditing procedure that the clarification thus accomplished makes it possible to simplify and improve the first paragraph of the short-form of accountant's report or certificate.

3. The committee believes that the first paragraph of the short-form report or certificate should be amended in the following respects:

(a) Exclude reference to the examination of the system of internal control.

(b) Exclude reference to the omission of a detailed audit of the transactions.

(c) Correct the inconsistent expression relating to auditing standards applicable in the circumstances.

4. The committee believes that it is no longer necessary or desirable to mention the examination of the system of internal control inasmuch as one of the generally accepted auditing standards is stated to be:

"There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the tests to which auditing procedures are to be restricted."

5. The test character of examinations by independent accountants has been made clear in the special report on auditing standards and in other literature published during the past several years. Therefore, it is the view of the committee that the words "and accordingly included such tests of the accounting records" in the second sentence of the first paragraph of the report or certificate as revised, is sufficient declaration of the test nature of the examination.

6. The last of the foregoing amendments was covered by a recommendation of the committee in its special report on auditing standards. This suggested change has already been adopted by a majority of the accounting profession in the reports or certificates relating to the year 1947.

7. The recommended revised short-form of accountant's report or certificate is presented below:

"We have examined the balance-sheet of X Company as of December 31, 19— and the related statement(s) of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

"In our opinion, the accompanying balance-sheet and statement(s) of income and surplus present fairly the financial position of X Company at December 31, 19—, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year."

APPENDIX

The following resolution was adopted by the members present at the annual meeting of the American Institute of Accountants in September, 1948:

WHEREAS the committee on auditing procedure of the American Institute of Accountants in a special report [*Tentative Statement of Auditing Standards*] issued in October, 1947, among other things has stated that

"While it is not practicable, because of the wide variance of conditions encountered, to issue anything like an 'all-purpose' program of auditing procedures it is possible to formulate a pronouncement with regard to the auditing standards requiring observance by the accountant in his judgment exercise as to procedures selected and the extent of the application of such procedures through selective testing." (Paragraph 6, page 7)

and that:

"Auditing standards may be said to be differentiated from auditing procedures in that the latter relate to acts to be performed, whereas the former deal with measures of the quality of the performance of those acts, and the objectives to be attained in the employment of the procedures undertaken. Auditing standards as thus distinct from auditing procedures concern themselves not only with the auditor's professional qualities but also with his judgment exercise in the conduct of his examination and in his reporting thereon."

(Part of the first paragraph, page 9)

and has presented the following brief summary of the meaning of generally accepted auditing standards (page 11):

"General Standards

1. The examination is to be performed by a person or persons having adequate technical training and proficiency as an auditor.

2. In all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors.

3. Due professional care is to be exercised in the performance of the examination and the preparation of the report.

"Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.

2. There is to be a proper study and evaluation of the existing internal control as a basis for reliance thereon and for the determination of the resultant extent of the

tests to which auditing procedures are to be restricted.

3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination.

"Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted principles of accounting.

2. The report shall state whether such principles have been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report."

Now Therefore Be It Resolved, That:

(a) The foregoing excerpts from the committee's report are hereby approved and adopted,

(b) The use of "generally accepted auditing standards" in the reports or certificates of independent auditors shall be deemed to refer to the standards or principles set forth in the foregoing summary, and

(c) The references on pages 10 and 12 of *Extensions of Auditing Procedure* [Statement on Auditing Procedure No. 1] to the Institute's 1936 bulletin *Examination of Financial Statements* are no longer applicable.

* * *

The statement entitled "Revision in Short-Form Accountant's Report or Certificate" was adopted by the assenting votes of sixteen members of the committee. One member, Mr. Harrington, dissented.

Mr. Harrington opposes the issuance of the statement because he questions the desirability of excluding from the accountant's report reference to the omission of a complete check of transactions. Notwithstanding his agreement with the other members of the committee that auditing standards ordinarily do not require a complete check of transactions, Mr. Harrington believes that a statement in the auditor's report to the effect that a detailed audit was not made is of continuing value as educating readers to a better appreciation of the character of the accountant's examination.

Committee on Auditing Procedure (1947-1948)

Paul Grady, *Chairman*
J. A. Boulay
Garrett T. Burns
William D. Cranstoun
Ralph H. Galpin
Henry I. Hamm
Russell C. Harrington
Gordon M. Hill
A. Joel Jackson
Alvin R. Jennings
Thomas L. Keaney
C. Alvin Koch
Malcolm Lamont
Ira B. McGladrey
Harold A. Mock
Norman H. S. Vincent
Karl R. Zimmermann

Carman G. Blough
Director of Research

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

The well-written article on the "Review of Auditing Case Study No. 3" by Alfred R. Marks, published in the October issue, contains many worthwhile suggestions for department store audits. However, may I comment on two sections thereof which I feel do not fully set forth the preferable treatment.

(1) Mr. Marks emphasizes that ". . . the accountant does not take the inventory, but merely observes the taking of it." He states that "The accountant's staff should circulate through the store during the inventory-taking . . . they should determine that the Comptroller's representatives are making sufficient test-checks".

However, Mr. Marks does not state that the auditor should make actual test-counts as a check on the client's employees. Mr. Marks also does not mention that the auditor should keep a control either of the inventory tags or inventory sheets recording the original counts, so the quantities thereon may later be test-checked *by the auditor* to the final listings submitted by the client.

If the foregoing two procedures are omitted, the auditor will not be in a position readily to detect intentional misstatements on the client's part and also is not independently test-checking quantities, thus omitting one of the main reasons for his presence at the inventory-taking.

(2) Mr. Marks also states ". . . it is ordinarily not practical or necessary to attempt to secure independent confirmations of liabilities because of the great difficulties entailed in reconciling such statements with the balances maintained on the voucher record."

Except in unusual cases, the list of open vouchers payable can be taken off by the client's employees at the closing date, and the items thereon can then be grouped alphabetically, by creditors, with the expenditure of a little additional time. Then, even if all vouchers cannot readily be reconciled to verification replies, a test-confirmation of active creditors' balances by direct correspondence may disclose unentered liabilities.

The reader is referred to page 252 of the September, 1948, Journal of Accountancy, for additional reasons in favor of the test-confirmation of accounts payable.

Very truly yours,

STEPHEN CHAN

New York, N. Y.

* * *

To the Editor of *The New York Certified Public Accountant:*

I have read, with great interest, the letter addressed to you under date of October 7, 1948, by Mr. Stephen Chan relative to my article on the "Review of Auditing Case Study No. 3—A Department Store" published in the October, 1948, issue and I am going to try to reply to some of Mr. Chan's comments.

First, Mr. Chan may have missed the import of the opening paragraph of my article in which I stress the point that the study "treats of a *specific case.* Although it appears to be typical of a retail audit, *the case under review has its own characteristics* such as size, method of operations, etc., and these distinguishing characteristics must be kept in mind during the study of the recommended auditing procedures".

Thus, what were reasonable and practical auditing procedures in the particular case in mind, might not have been reasonable and practical under different circumstances.

Next, Mr. Chan correctly points out that I do not state that—

> "the auditor should make actual test-counts as a check on the client's employees" and that "the auditor should keep a control either of the inventory tags or inventory sheets recording the actual counts, so that the quantities thereon may later be test-checked *by the auditor* to the final listings submitted by the client."

In "Extensions of Auditing Procedure" the following recommendations were made concerning inventories:

> "That hereafter, where the independent certified public accountant intends to report over his signature on the financial statements of a concern in which inventories are a material factor, it should be generally accepted auditing procedure that, in addition to making auditing tests and checks of the inventory accounts and records he shall, wherever practical and reasonable, be present, either in person or by his representatives, at the inventory-taking and *by suitable observation and inquiry satisfy himself as to the effectiveness of the methods of inventory-taking and as to the measure of reliance which may be placed upon the client's representations as to inventories and upon the records thereof.* In this connection the independent certified public accountant *may* require physical tests of inventories to be made under his observation."

In a prior paragraph of the "Extensions" it is stated that—

> "Management—is (also) charged with the *primary responsibility* to stockholders and to creditors for the substantial accuracy and adequacy of statements of position and operations."

I do not believe that the applicable recommendations in the "Extensions of Auditing Procedure" require that the auditor should make actual test-checks or keep control of the inventory sheets so that he may, later, test-check the quantities to the final listings. It does, however, charge him to satisfy himself by suitable observation and inquiry that there is an adequately controlled plan of inventory-taking under the responsibility of the controller or other executive assuming primary responsibility for the substantial accuracy and adequacy of the financial statements and that such plan is being rigidly and continuously adhered to.

Under the circumstances outlined in the specific case study under review it is my opinion that the audit procedures recommended would have satisfied the auditor as to whether or not the inventory was being properly and carefully taken and that the results thereof would be correctly reflected in the financial statements of the client. If his observations disclosed the necessity for such a procedure, the auditor might feel required to adopt the measures recommended by Mr. Chan but, in the absence of such indications, I do not feel that they are arbitrarily required of the auditor.

Also, Mr. Chan questions my statement that "it is ordinarly not practical or necessary to attempt to secure independent confirmation of liabilities because of the great difficulties entailed in reconciling such statements with the balances maintained on the voucher record". Mr. Chan may be correct with respect to my use of the word "ordinarily" but, under the circumstances existing in the case study under review, other reasonable and practical means are available to determine that all of the trade accounts payable have been properly recorded on the books without resorting to the often unsatisfactory responses to independent confirmation requests.

The system provided by the company appears to be designed to insure that when merchandise is received, a pre-numbered receiving record is prepared with one copy of such form being kept in the accounts payable department to control the recording of the liability. If, at the inventory dates, and at the end of the year, a record is made by the auditor of the last receiving number used, he can later scrutinize

the purchase journals of subsequent periods to determine that they do not contain invoices with receiving record numbers prior to the cut-off number. The results of this recommended procedure may provide the auditor with a better assurance that all liabilities were recorded than a comparatively small test by independent confirmation, the responses to which are so very often incorrect for any of the following reasons:

1. Information furnished as at a date other than the requested date.
2. Omission of "post-dated" invoices.
3. The late crediting of the fast anticipatory payments usually made by large retail stores.
4. Non-crediting of returns which have been charged back to the vendors.
5. Inability of vendors to comply with requests because their records are not maintained in a manner which permits them to provide the information.

It is granted that, where adequately controlled receiving records are not provided by the client to insure the proper recording of liabilities and where it is not possible for the auditor to satisfy himself by other reasonable and practical methods that the liabilities are so recorded, it will probably be necessary to request independent confirmations but such does not appear to be true in the case study under review.

Very truly yours,

ALFRED R. MARKS

New York, N. Y.

BOOK REVIEWS

How Tax Laws Make Giving to Charity Easy

By J. K. Lasser. FUNK & WAGNALLS COMPANY, New York, N. Y., 1948. Pages: xiv + 106; $3.00.

This interesting and useful book is an explanation of hundreds of methods available to help charitable, religious, educational and social institutions stimulate gifts in their favor by emphasizing the tax savings aspects of giving. While the mechanics of these methods are well known to tax practitioners, most donors are not readily conversant with them. This book informs taxpayers in simple language about the ways and means of making their gifts so as best to benefit both the recipient charity and the donor. For this reason, it should be an extremely valuable aid to all engaged in raising money for charitable and similar purposes, as well as to those contemplating such gifts.

E. S.

Words into Type

Based on Studies by Marjorie E. Skillin, Robert M. Gay, and other authorities. APPLETON - CENTURY - CROFTS, INC., New York, N. Y., 1948. Pages: xx + 585; $5.00.

This work furnishes a complete and easily understood compendium of the present-day rules and standards of usage involved in the publication of printed matter. It is presented in six Parts and an Appendix.

Part I deals with the preparation of the manuscript, including the technicalities of form, the special responsibilities of the book writer, and the legal responsibilities of the author. The techniques of preparing copy and reading proof are covered in Part II.

The neophyte will find Part III most informative. It affords a good technical coverage of typography and illustration, including a consideration of the problems of format and typographical style. Part IV, on Printing Style, comprises a discussion of the use of abbreviations, numbers, italics, capitals, punctuation, compounding and division of words, and foreign language composition problems.

Parts V (Grammar) and VI (Use of Words) afford adequate working guides for attaining correct usage. The Appendix contains glossaries of grammatical terms, of printing and allied terms, and of foreign words and phrases, as well as a list of book publishers.

The editor found the book to be a very adequate and helpful reference guide. Accountants concerned with the preparation and publication of reports, manuals, prospectuses, etc., should certainly profit from its use.

E. S.

The Federal Income Tax—A Guide to the Law

By Joyce Stanley & Richard Killcullan. CLARK BOARDMAN & CO. LTD., New York, N. Y., 1948. Pages: xv + 344; $6.00.

In the face of the existence of Mertens, Rabkin & Johnson, Montgomery and Lasser, as well as the various tax services, notably Commerce Clearing House, Prentice-Hall, Research Institute and Alexander, only a hearty soul would undertake to write such a book as the authors have done here. The authors have, however, made excellent progress in the direction of putting into layman's language the mass of tax material through which the spe-

cialist makes his way with more or less ease.

The book is directed to a varied "public". For the specialist the book seems to give a brief overview of any part of the Federal Income Tax law with which he is not too familiar. It is intended to give the lay attorney enough information about the tax law so that he may in his general practise have as much knowledge as he has of other specialties, especially a knowledge of when to call in the experts. It should also prove handy for those who, not being experts, would like to become such and would like some place to start their reading.

The book takes up the income tax provisions of the Internal Revenue Code, section by section, and in two or three places the Regulations, section by section. It gives the meat of these sections with some comments, where necessary, on departmental and judicial construction which has taken place. In many cases, the judicial and departmental construction of a section is even more important than what the statute specifically states, and the authors are equal to the demands of the situation. Thus, under Section 22(a), we find the concept of a constructive receipt explained at length, as well as the problems arising from the difference between the assignment of income and transfer of the property providing the income; also, the problems arising from a transfer in trust.

Some sections have been completely eliminated from the text except for mention for the purpose of retaining the section-by-section continuity. Here one might sometimes question whether the extra line required, for instance, to summarize Section 29.22(a)-16 should not have been used.

As in the case of any books written about a subject as current as taxes, the book is already somewhat out-of-date. Thus there is no discussion of the cases recently decided involving the decision as to the deductibility of that part of alimony which is really payable for the support of minor children where an analysis is necessary to determine the fact. Also, the authors mention only one *Trico Products* decison; the other must have been handed down since that portion of the book was completed.

Here and there the digesting results in what would appear to be a mis-statement of the law. True, the expert knows what the authors mean, but an author writing for the layman should be more careful in explaining exactly what he does mean. Sometimes, too, the authors seemed to slur over a section, as where they state that the rule (Section 116A) permitting exclusions from gross income for non-residents does not apply to alien residents. Naturally! Sometimes, too, an elision has taken place as in the second footnote on Page 299 where the authors forget to state, or at least to make clear, that a payment of tax with the right to a Tax Court decision retained must be made not only after the mailing of a notice of deficiency, but also after the filing of the petition with the Tax Court.

One section that it seems to the writer might well have been discussed, but was not, is Supplement T having to do with individuals with adjusted gross income of less than $5,000. Certainly a paragraph or two might well be spent on these provisions.

A very promising discovery was made when, turning to the back cover, a place for pocket parts was discovered. A book of this sort without provision for up-to-dating at regular intervals would be almost a waste of time. As it is, the book will well serve a group who are interested in the Federal Income Tax who cannot be served by any of the other sources now available.

RALPH G. LEDLEY

New York, N. Y.

pay-
ren
de-
hors
eci-
ded
ook

ults
ate-
pert
an
ould
ctly
too,
sec-
rule
ons
ents
nts.
sion
oot-
hors
ake
the
ned
ail-
also
the

the
sed,
ving
sted
Cer-
vell

was
ver,
dis-
out
ular
of
rve
ed-
ved
now

Y

See
mec
high
even
sma
savi
ing
tion

TH

19